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Would Harmonizing Preferential Rules of Origin Aid Trade Liberalization?

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WOULD HARMONIZING PREFERENTIAL RULES OF ORIGIN AID TRADE LIBERALIZATION?

by

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ABSTRACT

Rules of origin are those laws and regulations that are applied to determine the country of origin of goods. Upon the importation of a product, each country applies its own rules of origin to determine the origin of the product. Such origin rules are known as “non-preferential rules of origin”. However, there is another type of rules of origin called “preferential rules of origin”. They are used to stipulate whether a good is deemed to originate in a preferential trade agreement partner country and consequently eligible for preferential tariff treatment.

Unfortunately, preferential rules of origin have been misused by some countries to achieve protectionist, trade-diverting and political objectives. Misusing preferential rules of origin can lead to negative results and therefore does not facilitate international trade. In addition, the increase in the number of preferential trade agreements leads to the proliferation of preferential rules of origin worldwide. Their variations, along with their complexity, are considered to be a nightmare for producers and traders all over the world.

Harmonizing preferential rules of origin would eliminate their negative effects, thereby helping to liberalize international trade. This thesis discusses the negative effects that may result from the misuse of preferential rules of origin and gives realistic examples showing how the misuse of rules of origin in different preferential trade regimes hinders international trade. Also, the thesis offers the member countries of the World Trade Organization a proposed harmonized set of preferential rules of origin to be hopefully implemented in the World Trade Organization system. Moreover, the thesis theoretically tests the proposal and gives very deep and technical details on that.

DECLARATION

I hereby declare that the following Thesis has been composed by me, that the work of which it is a record has been carried out by myself, and that it has not been presented in any previous application for a higher degree.

LL.M by Research Student

Hatem Mabrouk

…….

CERTIFICATE

This is to certify that Hatem Mabrouk has done his research under my supervision, and that he has fulfilled the conditions of Ordinance 14 of the University of Dundee, so that he is qualified to submit the following thesis in application for the Degree of LL.M by research

Principal supervisor	Second supervisor
Robin Churchill	Kirsteen Shields
……	……

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I owe this thesis to my wife, mother and father whose lifetimes have been devoted for me.

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ABBREVIATIONS

AANZFTA	ASEAN-Australia-New Zealand FTA
AFTA	Association of Southeast Asian Nations Free Trade Agreement
ANZCERTA	Australia New Zealand Closer Economic Agreement
APEC	Asia-Pacific Economic Cooperation
APTA	Asia-Pacific Trade Agreement
ASEAN	Association of Southeast Asian Nations
CIF	Cost Insurance and Freight
CU	Customs Union
DR-CAFTA	Dominican Republic – Central America Free Trade Agreement
EC	European Community
EFTA	European Free Trade Association
EU	European Union
FOB	Free on Board
FTA	Free Trade Agreement
FTAA	Free Trade Area of the Americas
GATT	General Agreement on Tariffs and Trade
GSP	Generalized System of Preferences

HS	Harmonized Commodity Description and Coding System
MFN	Most-Favored-Nation
NAFTA	North American Free Trade Agreement
QIZ	Qualifying Industrial Zone
SAARC	South Asian Association for Regional Cooperation
SAPTA	South Asian Association for Regional Cooperation Preferential Trading Agreement
SG&A	Selling, General, and Administrative
TTIP	Transatlantic Trade and Investment Partnership
UK	United Kingdom
US	United States of America
WCO	World Customs Organization
WTO	World Trade Organization

CHAPTER I

INTRODUCTION

"While the primary aim of rules of origin is to ensure that preferences accrue only to the signatories of a preferential trade agreement, they are often complex and can act as a barrier to trade"[1]

World War I severed trade relations. At that time, no international organization existed to maintain trade relations or recreate balanced international trade.[2] On November 11, 1918, Germany surrendered to the Allied nations.[3] In 1919, Germany and the Allied forces signed the Peace Treaty of Versailles.[4] Under this treaty, Germany was obligated to pay war reparations to the Allies, mainly France and Great Britain. "These reparations cut into the financial resources of central Europe".[5]The recovery of Europe's economy was hindered, the amount of poverty increased, which led possibly to the emerging of the Fascist and Nazi movements in Italy and Germany in the 1920s and 1930s.[6]After World War I, Japan was the first country that practised protectionism on a very excessive level to protect itself from big markets like the United States (US) because it was very difficult for small-sized markets like Japan to globally compete and prosper.[7] On the other hand, Great Britain had inefficient production firms and its producers suffered from a low rate of the national demand. Thus, when Australia, New Zealand, India and Canada started to practise protectionism, Britain encountered hindrances when it came to exporting to and

[1] Eckart Naumann, 'Comparing EU free trade agreements - Rules of origin' [2006] (61) InBrief, 3.
[2] Gale Encyclopedia of U.S. Economic History, 'General Agreement on Tariffs and Trade (Gatt)' (1999) Retrieved June 08, 2012 from Encyclopedia.com <http://www.encyclopedia.com/doc/1G2-3406400356.html> accessed 13 June 2014.
[3] Harry R. Rudin, *Armistice 1918* (New Haven, CT: Yale University Press, 1967) 320-349.
[4] Koppel S. Pinson, *Modern Germany: Its History and Civilization* (13th printing edn, New York: The MacMillan Co., 1954), p. 397.
[5] Gale Encyclopedia (n 2).
[6] Ibid.
[7] Kerry A. Chase, *Trading Blocs: States, Firms, and Regions in the World Economy* (Ann Arbor: University of Michigan Press, 2005) 52, 65-66.

selling in Imperial markets.[8] Britain therefore tried to protect its firms on a national and global level to increase demand for their products.[9]Before World War II and during the period of the Weimar Republic, Germany gave up open trade.[10] To have a "self-sufficient" economy (autarky), Germany's New Plan of 1934 continued Germany's introduction of exchange controls that took place in 1931.[11]Between 1929 and 1933, Germany practised protectionism mainly in agricultural products.[12]In 1929 the Great Depression began and lasted until the early 1940s. The inapt financial policies in Europe and the United States and the collapse of the US stock market of 1929, commonly known as the Wall Street Crash, were the main triggers of the Depression. [13] During the 1930s, the practice of protectionism was on the rise.[14]Following the Wall Street Crash of 1929, the Smoot–Hawley Tariff Act was adopted by the US Congress in 1930.[15] The Act raised US tariffs on about 20,000 imported goods mainly to protect national farmers against competition from foreign agricultural imports.[16]Responding to the Smoot–Hawley Tariff Act, Italy and Spain imposed high tariffs on many US goods.[17] Many European countries were affected by such action and it led to trade war with the US.[18] Subsequently, Switzerland, Canada, Australia, Cuba, Mexico, France and New Zealand participated as well in

[8]For instance, in 1931 India increased its tariffs on British cotton fabrics from 3.5 % to 25 %. Ibid, 76.
[9]For example, the British automobile industry was in favour of protectionism and the British Dyestuff Importation Act was also adopted to increase the tariffs on dyestuffs and, consequently, prevent German competition. Ibid, 78.
[10] Kerry A. Chase, 'Imperial Protection and Strategic Trade Policy in the Interwar Period' (2004) 11 *Review of International Political Economy* 180.
[11] Ibid.
[12] Chase, *Trading Blocs: States, Firms, and Regions in the World Economy* (n 7) 88.
[13] World Bank, *World Development Report 1987* (New York: Oxford University Press, 1987), 139.
[14] Gale Encyclopedia (n 2).
[15] Tariff Act 1930, ch. 497, 46 Stat. 590 (1930) (codified at 19 U.S.C. §§ 1202-1654 (1930)).
[16] Mikhel Ruia, 'Will the Current Parlous State of the Economy Give Rise to Protectionist Sentiment?' [2009] (3) Durham University Investment and Finance Group, 1 <http://duifg.com/downloads/Market%20Reports/DUIFG%20Market%20Report%20Mar%2009.pdf> accessed 13 February 2014.
[17] In June 1930, Italy imposed high tariffs on hats and olive oil. In July 1930, Spain adopted the Wais Tariff which imposed high tariffs on many US goods, such as automobiles, tyres, tubes, motion-pictures films, cork, grapes, oranges and onions.
[18] World Bank (n 13) 139.

such trade war.[19]As a result, the Great Depression worsened and a severe drop in international trade took place.[20]Towards the end of World War II, in July 1944, the United Nations Monetary and Financial Conference, known also as the Bretton Woods Conference, took place at which the Allies gathered for the purpose of establishing institutions that would abolish the economic reasons for wars.[21] The conference led to the formation of two international organizations, namely the International Bank for Reconstruction and Development (the World Bank) and the International Monetary Fund.[22]In 1947, the General Agreement on Tariffs and Trade (GATT) was established as reaction against the protectionism that had hindered international trade and aided the expansion of the Great Depression.[23]

The GATT held eight rounds of negotiations and succeeded in gradually reducing the level of tariffs and urged trade facilitation between its member countries.[24]The Uruguay Round of Multilateral Trade Negotiations was the eighth round (1986-1994). It resulted in the conclusion of the Marrakesh Agreement and updated the GATT 1947 to the GATT 1994. The GATT 1994 included 12 additional side agreements. In 1995, the institutional machinery of the GATT was replaced by the World Trade Organization (WTO) under the Marrakesh Agreement.[25] Today, the WTO acts as the

[19] Switzerland imposed high tariffs on watches, shoes and embroideries and boycotted imports from the US. In August, 1932, Canada tripled its tariffs on food products, timber and logs. Ibid.
[20] U.S. Department of State, 'Hawley-Smoot Tariff' <http://future.state.gov/when/timeline/1921_timeline/smoot_tariff.html> accessed 13 February 2014.
[21] Donald Markwell, *John Maynard Keynes and International Relations: Economic Paths to War and Peace* (Oxford University Press 2006).
[22] Sandra Blanco and Enrique Carrasco, 'The Functions of the IMF and the World Bank' (2009) UICIFD Bretton Woods Project.
[23] Gale Encyclopedia (n 2).
[24] See Douglas A. Irwin, 'Free Trade Agreements and Customs Unions' (2002) The Library of Economics and Liberty: The Concise Encyclopedia of Economics <http://www.econlib.org/library/Enc/InternationalTradeAgreements.html#abouttheauthor> accessed 13 February 2014.
[25] World Trade Organization, 'The GATT Years: from Havana to Marrakesh' <http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact4_e.htm> accessed 14 August 2014.

umbrella for about 60 different agreements[26] and over 160 countries are members.[27] One of these agreements is the Agreement on Rules of Origin.

1.1 Articles I, III and XXIV of the GATT 1994.

There are two vital principles to the GATT: the Most-Favoured-Nation (MFN) principle and the National Treatment principle. Pursuant to Article 1 (General MFN Treatment) of the GATT 1994, a WTO member country is not allowed to discriminate between its trading partners. Accordingly, when a WTO member country lowers its customs duty rate for one of its goods coming from a particular member of the WTO, the same shall be done for all other WTO members.

Pursuant to Article III of the GATT 1994, WTO members are prohibited from adopting domestic policies designed to discriminate against foreign imported goods in favour of the same or similar locally-produced goods. For example, it is a violation of the GATT national treatment principle when a WTO member country imposes technical standards on imported goods that are more stringent than on similar domestic goods.

If certain conditions laid down in Article XXIV of the GATT 1994 are fulfilled, preferential trade agreements may be formed as a discriminatory exception to the MFN principle. A preferential trade agreement is a trade agreement between certain countries. It gives preferential tariff treatment to goods from countries that are parties to the agreement. A preferential trade agreement may be multilateral or bilateral. A multilateral trade agreement is formed between many countries. A

[26] World Trade Organization, 'WTO legal texts' <http://www.wto.org/english/docs_e/legal_e/legal_e.htm> accessed 13 August 2014.
[27] World Trade Organization, 'Members and Observers' <http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm> accessed 13 August 2014.

bilateral agreement is formed between two countries. Moreover, in 1979, the GATT adopted the "Enabling Clause" under which unilateral concessions may be made when a country unilaterally decides to grant preferential access to certain goods from another country or countries, such as the EU (European Union) Generalized System of Preferences (GSP) regime.[28] About 585preferential trade agreements had been notified to the WTO as of June 15, 2014.[29]Each preferential trade agreement has its own rules of origin.[30]

1.2 Rules of Origin in General.

Rules of origin are those laws and regulations that are applied to determine the country of origin of a particular good. A good is conferred origin if it was wholly obtained in the exporting country or has undergone a last substantial transformation there.

A wholly obtained good is a good that is produced entirely in the exporting country. It is either a natural product or a good produced from natural product in the exporting country, such as minerals extracted from soil or water, live animals, harvested vegetables or goods produced thereof.

The last substantial transformation is a concept used to determine the country of origin of the good when more than one country is involved in the production of the good, i.e. the importation of inputs from one or more country was needed to produce the good. The last substantial transformation may be indicated by three possible

[28] Yong-Shik Lee and others, *Law and Development Perspective on International Trade Law* (CUP 2011) 145.
[29] World Trade Organization, 'Regional Trade Agreements' <http://www.wto.org/english/tratop_e/region_e/region_e.htm> accessed 9 September 2014.
[30] Except Customs Unions. They do not have preferential rules of origin (illustrated later in this chapter).

means: the change in tariff classification, the value added or the specific manufacturing operation.[31]These three means are also recognized in Article 2(a) of the Agreement on Rules of Origin.

The change in tariff classification method relies on the Harmonized System (The Harmonized Commodity Description and Coding System or the HS).[32] The HS has been developed by the World Customs Organization (WCO) to classify the goods being traded between "all participating countries" by using names and numbers.[33] The goods in the HS are classified under up to 6-digit codes. However, WTO member countries are free to add more digits for more specific classification of products, like 8 or 10 digits. Under the change in tariff classification method, origin can be conferred when a product has undergone a change in tariff classification at the 2, 4, 6 or 8 to 10-digit levels. While the 2-digit level is called the tariff chapter, the 4-digit level is called the tariff heading, the 6-digit level is known as the tariff sub-heading and the 8 to 10-digit level is called the tariff item.[34]A change in tariff classification rule of origin could look like this:

[31] World Customs Organization, 'Rules of Origin –handbook' <http://www.wcoomd.org/en/topics/origin/overview/origin-handbook.aspx> accessed 15 August 2014.
[32] World Customs Organization, 'What is the Harmonized System (HS)?' <http://www.wcoomd.org/en/topics/nomenclature/overview/what-is-the-harmonized-system.aspx> accessed 15 August 2014.
[33] The number of countries or economic unions that apply the HS is 207 as of 28June 2014. See the World Customs Organization 'List of Contracting Parties to the HS Convention and countries using the HS' <http://www.wcoomd.org/en/topics/nomenclature/overview/list-of-contracting-parties-to-the-hs-convention-and-countries-using-the-hs.aspx> accessed 15 August 2014.
[34] Biswajit Nag and Debdeep De, 'Rules of origin and development of regional production network in Asia: case studies of selected industries' (2011) Asia-Pacific Research and Training Network on Trade, Working Paper Series 101, 4.

Change in tariff classification at the 2-digit level (chapter level):

Chapter	Tariff heading	Tariff Sub-heading	Product description	Rule of Origin
58	5806	5806.31	Other woven fabrics: of cotton	A change to sub-heading 5806.31 from any other chapter

Source: Author's example

Under the mentioned rule of origin, a manufacturer in an exporting country (country A) could produce woven fabrics by using cotton yarn imported from another country (country B) which falls under sub-heading 5206.25 of the HS. Thus, according to this example, origin would be conferred by a change in tariff classification from chapter 52 (which includes sub-heading 5206.25) for cotton-yarn to sub-heading 5806.31 (woven fabrics), i.e. the exporting producer's woven fabrics would be considered to originate in country A.

The value added criterion is different from the change in tariff classification because it does not rely on the HS when applied. It is in principle very straightforward, but often complicated to operate in practice since the methods of valuation differ from one agreement to another (discussed in chapter 3). In general, the value added criterion could be either the maximum allowed percentage of imported inputs or the minimum percentage of local inputs used to produce the good.[35]The imposition of the value added criterion could look like this:

[35] Joseph A. LaNasa III, 'An Evaluation of the Uses and Importance of Rules of Origin, and the Effectiveness of the Uruguay Round's Agreement on Rules of Origin in Harmonizing and Regulating Them' (1996) Jean Monnet Center – NYU School of Law Working Paper 9601.

Chapter	Tariff heading	Tariff Sub-heading	Product description	Rule of Origin
73	7302	7302.10	Rails	A maximum import content of 40%

Source: Author's example

So if an exporter in country A manufactured rails using inputs imported from other countries, the rails would be considered to originate in country A if the value of the imported materials was no greater than 40% of the value of the manufactured rails.

The specific manufacturing operation method is straightforward in principle, just like the value added, but sometimes requires too much technicality related to the operation that the product has to undergo. The manufacturing operation test could be either positive, by requiring certain materials to have been used or operations to have occurred in the exporting country if the goods are deemed to originate there, or negative, when the rule of origin prohibits the use of certain inputs or certain operations. Sometimes the positive or negative tests are clarified by clear statements and sometimes they are clarified by using the change in tariff classification method. The following is an example showing what a positive test might look like:

Chapter	Tariff heading	Tariff Sub-heading	Product description	Rule of Origin
61	6103	6103.10	Suits	The good (suits) is both cut and sewn in the territory of the exporting country

Source: Author's example

The following example shows how a manufacturing operation test could rely on the change in tariff classification test in a negative state:

Chapter	Tariff heading	Tariff Sub-heading	Product description	Rule of Origin
90	9002	900211	"Objective lenses: For cameras, projectors or photographic enlargers or reducers"	"Change to subheading 900211 from any other subheading, except from heading 9001"

Source: Author's analysis based on the Australia New Zealand Closer Economic Agreement (ANZCERTA) Annex G: Product Specific Rules of Origin

900211 is the sub-heading number under which the product is classified. The first two digits (90) represent the chapter. The first four represent the tariff heading (9002). According to the table, the product (objective lenses) classified under sub-heading 900211 could be conferred origin when goods classified under any other sub-heading are used in its production, except goods classified under heading 9001 (negative test).

Upon the importation of a product, each country applies its own rules of origin to determine the origin of the product. That is why rules of origin differ from one country to another. Such rules of origin are known as "non-preferential rules of origin". Non-preferential rules of origin are mainly used for gathering trade statistics, government procurement, carrying out origin marking and labeling requirements, and

the application of trade policy instruments such as anti-dumping duties, countervailing measures and quantitative restrictions.

However, there is another type of rules of origin called “preferential rules of origin”. Preferential rules of origin deal with preferential trade agreements. They are used to stipulate whether a good is deemed to originate in a preferential trade agreement partner country and consequently eligible for preferential tariff treatment.

1.3 Rules of Origin in Preferential Trade Agreements.

There are two kinds of preferential trade agreements, agreements establishing Free Trade Areas and agreements establishing Customs Unions (CUs). A Free Trade Agreement (FTA) is an agreement under which two or more countries agree to grant each other tariff free access for goods being traded between only them. However, each party to the agreement is imposes tariffs on the goods imported from countries which are not members of the free trade area (third countries). In FTAs, each member maintains its own restrictions on trade with third countries. Therefore, the external tariff of a member can be different (lower or higher) from the external tariff of another member of a FTA. That is why if lax rules of origin are imposed in a FTA, trade deflection (or the transshipment of goods) could take place. Trade deflection is the export of goods from a third country to a member of a FTA via the member of the FTA imposing the lowest external tariff in order to benefit from the FTA preferences when entering the market(s) of first member which imposes a higher external tariff. So, for example, in a FTA one member, country A, charges 10% customs duty on imported cars and another member, country B, charges 30%, and there were no rules of origin governing trade between members of that FTA, an exporter of cars in a third

country might find it cheaper to export cars to country B by exporting the cars first to country A, where it pays 10% duty and then re-exporting the cars duty free from country A to country B, thereby circumventing country B's 30% duty. This phenomenon is known as a deflection of trade. Preferential rules of origin between members of a FTA are designed to prevent such deflections of trade.

A CU is formed when two or more countries agree to grant tariff free access to goods traded between them and apply a common external tariff to goods imported from non-members (third countries). In other words, unlike FTAs, all of the CU members agree to impose the same (not different) tariff rates on imports coming into the CU which leaves no room for deflection of trade to take place. Thus, there is no need for preferential rules of origin in CUs when it comes to internal trade (within the trade area) because of the common external tariff.

FTAs and CUs can be multilateral, such as the Association of Southeast Asian Nations Free Trade Agreement (AFTA) and the European Union Customs Union, or bilateral, such as the US-Singapore Agreement and the Switzerland-Liechtenstein CU.

1.4 Addressing the Thesis Issue.

Although preferential rules of origin play an increasing role and are an important issue in international trade because of the number of preferential trade agreements, such rules can be used in ways that can obstruct international trade. Even though the primary purpose of preferential rules of origin is to identify the beneficiaries of tariff preferences, the incidental effect of such rules may be protectionist when countries use preferential rules of origin as alternative barriers to trade to protect their own national interests and goods susceptible to adverse

competition from imports by imposing too stringent rules of origin. Using rules of origin as replacement barriers to trade has been called the "Law of Constant Protection" by Bhagwati.[36] The formation of preferential trade agreements has its positive effects on international trade, which will be explained in the next chapter. However, the imposition of too stringent preferential rules of origin in preferential trade agreements and the propagation of preferential rules of origin worldwide because of the formation of many preferential trade agreements have contributed to hindering international trade.

A country could use the preferential tariff as a bait to induce another to form together a preferential trade agreement. Because of such inducement, sometimes the latter country does not pay appropriate attention to the rules of origin when concluding the trade agreement. Also, sometimes all members of a preferential trade area agree to impose protectionist rules of origin so as to divert trade from an economically efficient external source of supply (outside the preferential trade area) to an inefficient internal one (within the trade area). In this thesis, efficiency refers to the ability to produce a good at its lowest average cost using the fewest resources possible. Thus, the efficient producer is the one who is able to produce goods intended to be sold to consumers for lowest competitive price. It is to be noted, though, that goods may be able to be produced more "efficiently" because in the country of production social, safety, and environmental standards are low, e.g., the use of child labour, paying women less than men, unsafe machinery, few or no pollution controls, etc. This is a big issue that needs a lot of discussion and is beyond the scope of this thesis, which is only concerned with the misuse of preferential rules of origin.

[36] Jagdish Bhagwati, *Protectionism* (Cambridge, Massachusetts.: MIT Press 1988). See also Simon P. Anderson and Nicolas Schmitt, 'Non-Tariff Barriers and Trade Liberalization (2000) University of Virginia, Department of Economics, Working Paper 340, 1 <http://www.virginia.edu/economics/RePEc/vir/virpap/papers/virpap340.pdf> accessed 13 August 2014.

Accordingly, any further discussions in this thesis related to efficiency will focus on the economic value of goods, not the environment of their production.

Added to the mentioned points, sometimes rules of origin are imposed in preferential trade agreements for political purposes. Each of the points is discussed in more detail in Chapter II. Examples of all these points are provided in the next chapter as well.

1.4.1 Protectionism.

In general terms protectionism is used to make certain that domestic producers are protected from adverse competition from foreign producers and from the possible avidity of domestic consumers for imported goods. This can happen by the imposition of tariffs on imported products, restrictive rules of origin and other trade regulations created by governments. Protectionism is the economic policy of shackling trade among countries. With the spread of protectionist motivations, preferential rules of origin have been used as protectionist apparatuses.

A too stringent preferential rule of origin may be costly if it requires a producer in a member country of a FTA, when producing the finished product for export to another member of the FTA, to source components from within the FTA that are more expensive than components from outside the FTA. This makes the exported product more expensive than it might otherwise have been, thereby providing some protection to producers making the same goods in the importing country. Also, a too stringent preferential rule of origin could be complex when it requires the producer to comply with complicated production operations within the trade area when producing the final product. In preferential trade systems (in FTAs

and unilateral concessions, but not in CUs), rules of origin play a considerable role in avoiding trade deflection. However, too stringent rules of origin are applied in many preferential trade agreements not mainly to avoid trade deflection, but for protectionist purposes, where the stringency of the rules of origin becomes more than that required to avoid trade deflection. As a result, complying with the indicated rules of origin will require costly and/or complex operations to be taken, and hence the entry of the sensitive competitive goods under the preferential trade agreements preferences to the markets protected by the imposition of the preferential trade agreements' restrictive rules of origin will be shackled.[37]

Although developing countries usually lack the employment of advanced operations when it comes to producing goods, they are characterized by inexpensive labour outlays needed during production processes. So, for example, they benefit from the production of textiles since excessive expenditure and/or advanced operations are unnecessary to set up an enterprise in that industry.[38] These factors induce developed countries to form a preferential trade agreement with or grant preferences to developing countries to encourage investment and the establishment of manufacturing firms there. On the other hand, as aforementioned, the preferential tariff could induce the preference-granted country to form a preferential trade agreement with the preference-granting country without paying appropriate attention to the rules of origin when concluding the trade agreement. As a result, the preference-granting country could attempt to protect its domestic products by imposing too stringent rules of origin on the competing products of developing countries trying to enter the market of the former under accorded preferences. Consequently, complying with the mentioned

[37] Paul Brenton, 'Enhancing Trade Preferences for LDCs: Reducing the Restrictiveness of Rules of Origin' in Richard Newfarmer (ed), *Trade, Doha, and Development: A Window into the Issues* (Washington DC: World Bank 2006) 281-287.
[38] Ibid 283.

rules of origin would require costly and complex operations to be taken by the developing country which would prevent it from profiting from the accorded preferences and make it exceedingly difficult for its textiles to compete in the market of the preference-granting country. Thus, the developing country might not take advantage of the preferences and instead choose to trade with the preference-granting country on a MFN basis since this would not charge it the costly and the complex operations needed to be taken. Examples and detailed explanation for the problem of using rules of origin as protectionist tools are clarified in Chapter II.

1.4.2 Trade Diversion.

Preferential rules of origin have been used as trade-diverting tools, i.e. diverting trade from efficient sources of supply[39] to inefficient sources of supply[40]. The imposition of stringent rules of origin in preferential trade regimes results in trade diversion when a final good producer switches its importation of inputs from an efficient external source of supply (located outside the preferential trade area) to a less efficient internal one (located inside the preferential trade area) in order then for the producer to comply with the preferential trade agreement's stringent rules of origin when producing the final goods and thus trade in such goods under the preferential trade agreement's preferences. Hence, the imposition of trade-diverting rules of origin affects global efficiency negatively since it increases production by inefficient

[39] I.e., Producers of cheap goods.
[40] I.e., Producers of costly goods.

producers in preferential trade areas and shrinks production by efficient third countries' producers.[41]

1.4.3 The Proliferation of Preferential Rules of Origin.

Preferential rules of origin vary from one preferential trade agreement to another. Their variations, along with their complexity, are considered to be a nightmare for producers and traders all over the world and have led to the so-termed "Spaghetti Bowl" phenomenon.[42] For instance, things are complex for a trader whose country is a member of a variety of preferential trade agreements that impose different preferential rules of origin to be complied with. Enterprises also face difficulties when complying with a diversity of administrative costs provoked by different agreements.[43]

1.4.4 Political Purposes.

In most cases, the primary purpose for concluding preferential trade agreements requires economic cooperation to increase trade between the countries parties to such agreements. However, preferential trade agreements could also be the expression of a political purpose. For example, the EU was formed after the Second World War for the purpose of achieving peace and prosperity within the EU. Therefore, the political ties between countries could affect their trading relations. As a

[41] Robert Z. Lawrence, 'Regionalism and the WTO: Should the Rules be Changed?' In Schott, Jeffrey J. (ed.), *The World Trading System: Challenges Ahead* (Institute for International Economics, Washington DC 1996) 52.
[42] Jagdish Bhagwati and Arvind Panagariya, 'The Theory of Preferential Trade Agreements: Historical Evolution and Current Trends' (1996) American Economic Review Papers and Proceedings, 82-87.
[43] Sanjay Pandey, 'Spaghetti Bowl Phenomenon and Crucification of Multilateralism: Task Ahead for WTO' (2006) Amity Law School, Working Paper Series 78, 6.

result, preferential rules of origin could be used as devices that are designed to pursue political aims.

An example of using rules of origin to achieve political goals is the US designation of Qualified Industrial Zones (QIZs) between Egypt and Israel and Jordan and Israel for the purpose of supporting peace process in the Middle East. Accordingly, Egypt and Jordan have been allowed to export products to the US duty free, if the value of Israeli components used to produce the final Egyptian and Jordanian products are 11.7 % and 8 %, respectively, of the final product value.[44] This raises the question of whether rules of origin were designed for political purposes. Of course not, because international cooperation and peace processes do not have anything to do with rules of origin.

The negative consequences of using rules of origin as imperative political-aims-pursuing tools are reflected in the number of the Egyptian manufacturing firms that export to the US under the QIZ[45] protocol (as will be clarified in Chapter II).

1.4.5 Summary.

Using preferential rules of origin for protectionist and trade-diverting purposes, the complexities caused by the proliferation of preferential rules of origin worldwide, and the use of preferential rules of origin to pursue political aims are all obstacles to international trade. The misuse of preferential rules of origin is what they all have in common. Hence, trade has been hindered and is practised pursuant to different

[44] State of Israel Ministry of Trade & Labor, 'Q.I.Z – Qualifying Industrial Zones' <http://www.moit.gov.il/NR/exeres/2124E799-4876-40EF-831C-6410830D8F02.htm> accessed 13 February 2014.
[45] Sometimes referred to as the "QUIZ".

national, and even political, interests because of the way in which preferential rules of origin are being used.

1.5 The Thesis Question.

As a contribution towards addressing the issues hindering international trade because of the misuse of preferential rules of origin, this thesis will investigate the possibility of harmonizing preferential rules of origin in order to prevent such misuse and consequently facilitate international trade. Hence, the thesis hypothesizes that harmonizing preferential rules of origin would eliminate the negative effects outlined previously, thereby helping to liberalize international trade.

To build up the research hypothesis, first I will discuss (in Chapter II) the negative effects of preferential rules of origin and give realistic examples showing how the misuse of rules of origin in different preferential trade regimes hinders international trade. Second (in Chapter III), I will address the possibilities of achieving a proper harmonization of preferential rules of origin and give very deep and technical details on how to do that. Third (in Chapter IV), I will show how the main proposal about harmonization will be set out and how it will be tested.

From the above mentioned hypothesis, the thesis question can be stated as: Would the harmonization of preferential rules of origin aid trade liberalization?

1.6 Testing the Thesis Hypothesis.

The thesis aims at proving that harmonizing preferential rules of origin would eliminate the negative effects of the misuse of preferential rules of origin. Since

preferential rules of origin have not been harmonized, it will not be possible to test the thesis hypothesis empirically. That is why I will have to use a theoretical model for doing so in relation to each of the problem areas identified in section 1.4 above and Chapter II below. Thereupon, I intend to apply theoretically the model harmonization of preferential rules of origin to each problem and show, consequently, possible positive results proving and supporting the thesis hypothesis. For instance, after having given a detailed model of harmonized preferential rules of origin, I will show in theory the effect of such harmonized rules on eliminating protectionism. With a set of harmonized preferential rules of origin, the parties to preferential trade agreements will be prevented from misusing rules of origin and imposing protectionist rules of origin pursuant to their national interests. As a result, international trade will be facilitated. Also, the substantive content of the harmonized rules of origin that will be discussed in Chapter III could, presumably, lead to other positive results when tested. For example: (1) there would be fair competition and global production efficiency; (2) too costly and/or complex operations would not be needed to comply with preferential rules of origin, which would facilitate exportation and importation processes and increase the utilization rates of preferences in preferential trade areas; and (3) consumers all over the world would be provided with greater choices. This will be discussed in more detail later in this thesis.

By doing the same with each problem, i.e. applying the harmonized model of rules of origin to each problem, I will demonstrate the possible positive outcomes showing how harmonizing preferential rules of origin would eliminate the negative effects of misusing preferential rules of origin, thereby helping to liberalize international trade.

CHAPTER II

THE MISUSE OF PREFERENTIAL RULES OF ORIGIN

Even though preferential rules of origin are designed to determine whether the imported good qualifies for preferential treatment, their imposition in some preferential trade agreements is sometimes done to pursue other objectives. Such objectives hinder international trade and turn it to a nightmare for producers and traders.

The WTO Agreement on Rules of Origin establishes certain disciplines for non-preferential rules of origin. The WTO member countries shall comply with these disciplines until the completion of the Harmonization Work Programme to ensure the partial, transparent and clear application of non-preferential rules of origin. However, Annex II of the agreement does not set down the same disciplines on preferential rules of origin. As a result, WTO member countries could use preferential rules of origin to protect their national interests and products from competition with foreign producers. Moreover, in a preferential trade area, when a final product is produced, rules of origin could become a tool used to alter the importation of inputs from cheap producers outside the area to a costly producer inside it. This negatively affects global efficiency and leaves consumers with limited and costly choices. Also, the imposition of preferential rules of origin could depend on the foreign policies of countries. This leads sometimes to the usage of rules of origin to pursue political goals. This does not make trade smooth, transparent and predictable for traders. Lastly, the formation of preferential trade agreements, under article XXIV of the GATT, and the enormous increase in their number led to what is known as the spaghetti bowl phenomenon. Accordingly, a country could be a member of a preferential trade agreement that

imposes different rules of origin and also a member of another agreement that imposes other rules of origin. This leaves traders and producers confused by the complexity resulting from the proliferation of rules of origin worldwide.

The purpose of this chapter is to discuss and give examples of all the mentioned negative effects resulting from the misuse of preferential rules of origin.

2.1 Do Preferential Rules of Origin Lend Themselves to Being Used For Protectionist Purposes?

This Section answers the question of the whether preferential rules of origin lend themselves to being used for protectionist purposes. First, it defines protectionism and talks about the position of the WTO towards protectionism. Second, it gives examples that could clarify the use of rules of origin for protectionist purposes. Lastly, the chapter suggests certain solutions to overcome the problem of using rules of origin as protectionist instruments in some trade regimes.

Protectionism is used to protect domestic producers from competition from foreign producers and from the possible avidity of domestic consumers for imports by the imposition of tariffs on imported products, stringent quantitative restrictions, restrictive rules of origin and other trade regulations created by governments. It is the economic policy of shackling trade between countries. Thus, protectionism can take many forms. However, this section is going to focus on and discuss the possible protectionist implementation of preferential rules of origin in some preferential trade regimes.

As mentioned in Chapter I, the WTO fights protectionism and aims to liberalize trade among its member countries. For that reason, the WTO is the most powerful fortress against protectionism.[46]

2.1.1 The WTO Agreement on Rules of Origin.

It will be argued in this thesis that rules of origin have been used as protectionist tools in a variety of trade regimes by, specifically, developed countries. That is why the WTO Agreement on Rules of Origin was concluded in 1994 under the Uruguay Round of the Multilateral Trade Negotiations of the WTO. The Agreement on Rules of Origin was formed in order for WTO member countries to comply with a regular set of harmonized rules when specifying the origin of a product for the purpose of applying MFN treatment and to prevent such rules from becoming obstacles to trade. However, pursuant to Article 1 of the Agreement, non-preferential rules of origin, when harmonized, would not apply in preferential trade regimes.

Article 1 of the Agreement on Rules of Origin illustrates the main uses of non-preferential rules of origin, including: determining whether the imported goods shall qualify for MFN or preferential treatment, gathering trade statistics, government procurement, carrying out origin marking and labeling requirements and the application of trade policy instruments. Accordingly, one of the roles of rules of origin is to implement and support trade policy instruments instead of replacing or supplementing them. Hence, rules of origin shall not be used for protectionist

[46] Carla A. Hills, 'How the WTO Fights Protectionism' (2007) IIP Digital 2007, <http://iipdigital.usembassy.gov/st/english/publication/2008/06/20080608132704xjyrrep0.1592981.html#axzz3AiJi7SDu > accessed 17 August 2014.

purposes or to favour the imported goods of one country over the imported goods of another.[47]

Article 2 of the Agreement on Rules of Origin contains a list of disciplines that shall be followed until the completion of the Harmonization Work Programme (during the transition period). These disciplines clarify that non-preferential rules of origin:

a) Shall be "defined" in a transparent, clear and precise manner when imposed on the good;
b) Shall not be used to "pursue trade objectives";
c) Shall not restrict, distort or disrupt international trade;
d) "Shall not be more stringent than the rules of origin applied to determine whether the good is domestic" (National Treatment principle);
e) "Shall not discriminate between other members irrespective of the affiliation of the manufacturers of the good concerned" (MFN principle); and
f) "Shall be administered in a uniform, impartial and reasonable manner."

Therefore, using non-preferential rules of origin for protectionist purposes violates Article 2 of the Agreement on Rules of Origin as well. That was illustrated by the United States – *Rules of Origin for Textiles and Apparel Products*.[48]

Unfortunately, the Agreement on Rules of Origin does not provide disciplines for the application of preferential rules of origin as same as those provided for the application of non-preferential ones, thus permitting the possible misuse of preferential rules of origin. Annex II of the Agreement on Rules of Origin (Common

[47] Agreement on Rules of Origin (April 15 1994) 1868 UNTS 397, art 1(1) <http://www.wto.org/english/docs_e/legal_e/22-roo.pdf> accessed 17 August 2014.
[48] United States – Rules of Origin for Textiles and Apparel Products – Report of the Panel (20 June 2003) WT/DS243/R.

Declaration with Regard to Preferential Rules of Origin) does no more than stipulate that preferential rules of origin shall clearly define the methods of origin determination; be based on the positive standard; be published pursuant to Article X:1 of the GATT; and not be retroactively applied. The following sub-sections give examples of how preferential rules of origin are used as protectionist instruments.

2.1.2 The NAFTA

Many believe that the NAFTA rules of origin are one of the most complex sets of rules of origin applied in preferential trade regimes.[49]

By using all three means of determining origin (the change in tariff classification, the regional value content requirement and the specific manufacturing operation),[50] the NAFTA rules of origin[51] are imposed on products classified "mostly at the 6-Digit tariff line level" of the HS.[52]

The stringency of the NAFTA rules of origin is mainly evident when the combination of more than one means of determining origin becomes a single rule that it is necessary for a product to comply with, for instance, the rule that requires a product to comply with a change in tariff classification along with a value content requirement is more restrictive than a rule requiring solely a change in tariff classification. Furthermore, the restrictiveness of the change in tariff classification test

[49] Antoni Estevadeordal, Jeremy Harris and Kati Suominen, 'Multilateralising Preferential Rules of Origin around the World'(2009) Inter-American Development Bank, Working Paper Series #IDB-WP-137, 28.
[50] All three methods of determining origin are explained in chapter 1.2.
[51] North American Free Trade Agreement (United States-Canada-Mexico) Annex III (12 December 1992) US Gov't Printing Office (1992), entered into force 1 January 1994 <https://www.nafta-sec-alena.org/Default.aspx?tabid=97&ctl=SectionView&mid=1588&sid=e9276e1c-a41e-4d33-a02c-61fdaec23bf4&language=en-US> accessed 17 August 2014.
[52] Antoni Estevedeordal, 'Negotiating Preferential Market Access: The Case of NAFTA' (2000) 34 *Journal of World Trade* 12.

varies according to the level at which the required change should occur (i.e. a change of tariff chapter is more restrictive than a change of tariff heading; which in turn is more restrictive than a change in tariff-subheading; which in turn is more restrictive than the change in tariff item).[53] Moreover, the value of the non-originating inputs permitted to be utilized under the tolerance rule (or the de minimis rule), which treats a fixed proportion of non-originating components used in producing a final product as if they are originating,[54] is set at only 7%.[55] Moreover, in the case of textiles, the tolerance rule is based on the weight of textile products instead of the value of non-originating inputs.[56] Besides, the tolerance rule "does not extend to the production of dairy produce, edible products of animal origin, citrus fruit and juice, instant coffee, cocoa products, and some machinery and mechanical appliances."[57] Under the NAFTA, nearly 75% of all of classified products are required to undergo a change in tariff chapter or a change in tariff heading in order to be conferred with the "originating status." In addition, 9% and 13% of them must comply with value content requirements and specific manufacturing operation.[58] The effect of such stringent rules of origin is reflected in Mexican exports for made little use of NAFTA preferences.[59]

[53] Ibid.
[54] mairiM Manchin and Annette O. Pelkmans-Balaoing, 'Rules of Origin and the Web of East Asian Free Trade Agreements' (2007) World Bank Policy Research, Working Paper 4273, 6.
[55] This value is considered to be low, especially if compared with the tolerance rules of other preferential regimes. For example, under the EU GSP regime and the Cotonou agreement the *de minimis* amount is set at 10% and 15%. See Paul Brenton, 'Notes on Rules of Origin with Implications for Regional Integration on Southeast Asia' (2003) Paper Presented at Pacific Economic Cooperation Council Trade Forum, 28 <http://www.pecc.org/publications/papers/trade-papers/4_ROO/2-brenton.pdf> accessed 16 August 2014.
[56] North American Free Trade Agreement (n 51), ch 4, art 405.
[57] Estevadeordal, Harris and Suominen, 'Multilateralising Preferential Rules of Origin' (n 49) 18.
[58] Kerry A. Chase, 'Industry Lobbying and Rules of Origin in Free Trade Agreements' (2007) International Studies Association 48th Annual Convention, 21.
[59] Estevadeordal, Harris and Suominen, 'Multilateralising Preferential Rules of Origin' (n 49) 7.

2.1.2.1 Automobiles.

One of the stringent NAFTA rules of origin concerns automobiles for which a high regional value content requirement of 62.5% is imposed on "automotive goods" to be calculated by using the net cost method.[60] In this case, the change in tariff classification test is not enough to be solely applied without the value content requirement rule.[61] The aim of imposing such a stringent NAFTA rule of origin is to make it difficult for Japanese and German automakers (Volkswagen, Toyota, Nissan and Honda), based in Canada and Mexico, to acquire the NAFTA preferences, when exporting to the US, and compete with the US automakers (the big three: General Motors, Chrysler and Ford) in the US market. Sourcing inputs from North America instead of Japan and Germany[62] puts the Japanese and German automakers at a price disadvantage and is thus deemed to be a difficult task for them to do,[63] unlike the American automotive industry that is easily able to comply and acquire accordingly the preferences.[64]

The pressure for the imposition of the stringent rules of origin concerning automotive products has been largely carried by the US "automakers" *Chrysler* and *Ford* and US "[a]uto parts makers."[65] Even though the imposition of the 62.5%

[60] Regional Value Content = Net cost - Value of non Originating Materials/ Net cost x 100. North American Free Trade Agreement (n 51), ch 4, art 402 (3).
[61] Ibid ch 4, art 403.
[62] In case the Japanese automakers seek complying with the regional value content requirement to acquire consequently the preferences.
[63] In other words, beside the large amount of capital needed to establish in the region and invest there, the emulators will have to source from the region inputs that could be less efficient if compared to those they might have used to source from.
[64] Chase, 'Industry Lobbying and Rules of Origin in Free Trade Agreements' (n 58) 34. See also Malcolm Fairbrother, 'Why Do Capitalists Hang Together on Trade? Business Unity in the Case of NAFTA' (2008) paper presented at the Annual Meeting of the International Studies Association, San Francisco, 24-31.
[65] Vivian C. Jones and Michael F. Martin, 'International Trade and Rules of Origin: Implications of Globalized Manufacturing' (2008) Congressional Research ServiceRL34524, 9 (quoting Frederick W. Mayer, *Interpreting NAFTA: The Science and Art of Political Analysis* 157-158 (1998)).

regional value content rule is very high. *Chrysler* and *Ford* actually sought the imposition of a higher regional value content of about 70% in order to guard themselves more from their foreign rivals.[66] Thus, the more or less successful lobbying by the US car firms supports the view that rules of origin can be used for protectionist purposes.

2.1.2.2 Ketchup.

Another protectionist NAFTA rule of origin concerns ketchup. This stipulates for ketchup to have originating status, there may be "a change to tariff item 2103.20.aa from any other chapter, except from subheading 2002.90."[67] This rule grants originating status for ketchup (2103.20) that is produced from imported tomatoes (any other chapter). However, the rule does not allow for ketchup to be manufactured from a tomato paste that is not sourced regionally (2002.90).[68] Otherwise, ketchup will not be granted originating status and will thus not be eligible to be exported regionally under preferences. So fulfillment of the change in tariff classification test will not be achieved under the NAFTA rules of origin, if ketchup is produced using imported tomato paste from outside NAFTA.

Canada was allowed to use imported Chilean tomato paste when producing ketchup to be exported to the US under the former Canada – US Free Trade Agreement.[69] That is not the case now in NAFTA. It appears that the stringent NAFTA rule of origin for ketchup has been imposed to induce ketchup producers in

[66] Ibid.
[67] North American Free Trade Agreement (n 51) Annex 401.
[68] Such exception is known as the "negative test", which means that satisfying the change in tariff classification will not grant the originating status to the product, if the exception is not respected. See Brenton 'Notes on Rules of Origin with Implications for Regional Integration on Southeast Asia' (n 55) 20.
[69] Ibid.

Canada and the US to source the needed paste from Mexican tomato paste producers rather than from those of Chile who sell it at a cheaper price due to their efficiency.[70] Therefore, the whole rule has been used as a protectionist apparatus: to protect Mexican producers against competition from the Chilean tomato paste producers.

2.1.2.3 The Triple Transformation Rule under NAFTA.

One of the facts that proves the stringency of NAFTA rules of origin is the imposition of the triple transformation rule on textile products "that are made of cotton or man-made fibers." Such a rule is typically used for protectionist purposes,[71] i.e. to protect the US textile producers from competition against Mexican textile producers and US textile producers who are based in Mexico: by impelling the latter producers to source the materials needed for producing the textiles from the US instead of Asia[72] (where the efficient producers are).[73]

Pursuant to the NAFTA triple transformation rule, with an exception of 7 % *de minimis* provided under the agreement, all of the textile production processes must take place regionally, i.e. in North America, if a product is to have originating status under NAFTA. It is as if a 100 % regional value content requirement is imposed on textile products.[74]

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[70] See Asian Development Bank, *Asian Development Outlook 2006: Routes for Asia's Trade* (Manila, Philippines 2006) 2 <http://www.adb.org/publications/asian-development-outlook-2006-routes-asias-trades> accessed 17 August 2014.
[71] Mariana C. Silveira, 'Rules of Origin in International Treaties: Comparative Study of NAFTA and MERCOSUR, and a General Overview of the European Union' (2001) LL.M. Thesis, the National Law Centre for Inter-American Free Trade, 56.
[72] Stefano Inama, *Rules of Origin in International Trade* (CUP 2009) 278.
[73] Rupa Duttagupta and Arvind Panagariya, 'Free Trade Areas and Rules of Origin: Economics and Politics' (2003) International Monetary Fund, IMF Working Paper 03/229, 26.
[74] Ibid.

According to the WTO Agreement on Rules of Origin, "Rules of origin should be objective, understandable and predictable."[75] Admitted by this applies only to non-preferential rules of origin. Nevertheless, in addition to the fact that the triple transformation rule is stringent, it is exceedingly complicated.[76] Consequently, it makes it hard for many traders and producers to understand, and to comply with it, especially those who are trying to run a production firm and who are involved in trade for the first time.

It was the US clothing industry that pressed for the application of the triple transformation rule in the NAFTA.[77] One of the primary reasons for this [78] was to require the US clothing production firms that had relocated to Mexico (to take advantage of the inexpensive labour)[79] to use materials sourced from the US without giving them the option to use instead imported Asian materials when producing textiles exported under the NAFTA to the US.[80] So in other words, the triple transformation rule of origin is to protect the US clothing firms based in the US against US firms based in Mexico.

In preferential trade systems, rules of origin play a considerable role in avoiding trade deflection (transshipment of goods). However, sometimes too stringent rules of origin are applied in preferential trade agreements, not to primarily avoid trade deflection, but to protect susceptible national products of some of the parties to preferential trade agreements, as evidenced by the fact that rules of origin

[75] Agreement on Rules of Origin (n 47) Art 9(c).
[76] Jones and Martin (n 65) 7.
[77] K.N. Harilal and P.L. Beena, 'The WTO Agreement on Rules of Origin: Implications for South Asia' (2003) Centre for Development Studies Working Paper 353, 20.
[78] The word "one" is mentioned because avoiding trade deflection could be another reason for the application of the triple transformation rule. However, such reason is usually used as an excuse for the application of stringent rules of origin.
[79] Michael G. Wilson, 'The North American Free Trade Agreement: Gauging Its Impact on the U.S. Economy' (1993) Heritage Lecture 468 <http://www.heritage.org/research/lecture/hl468nbsp-the-north-american-free-trade-agreement> accessed 17 August 2014.
[80] M. Angeles Villarreal, 'Industry Trade Effects related to NAFTA' (2002) Congressional Research Service RL31386, 8.

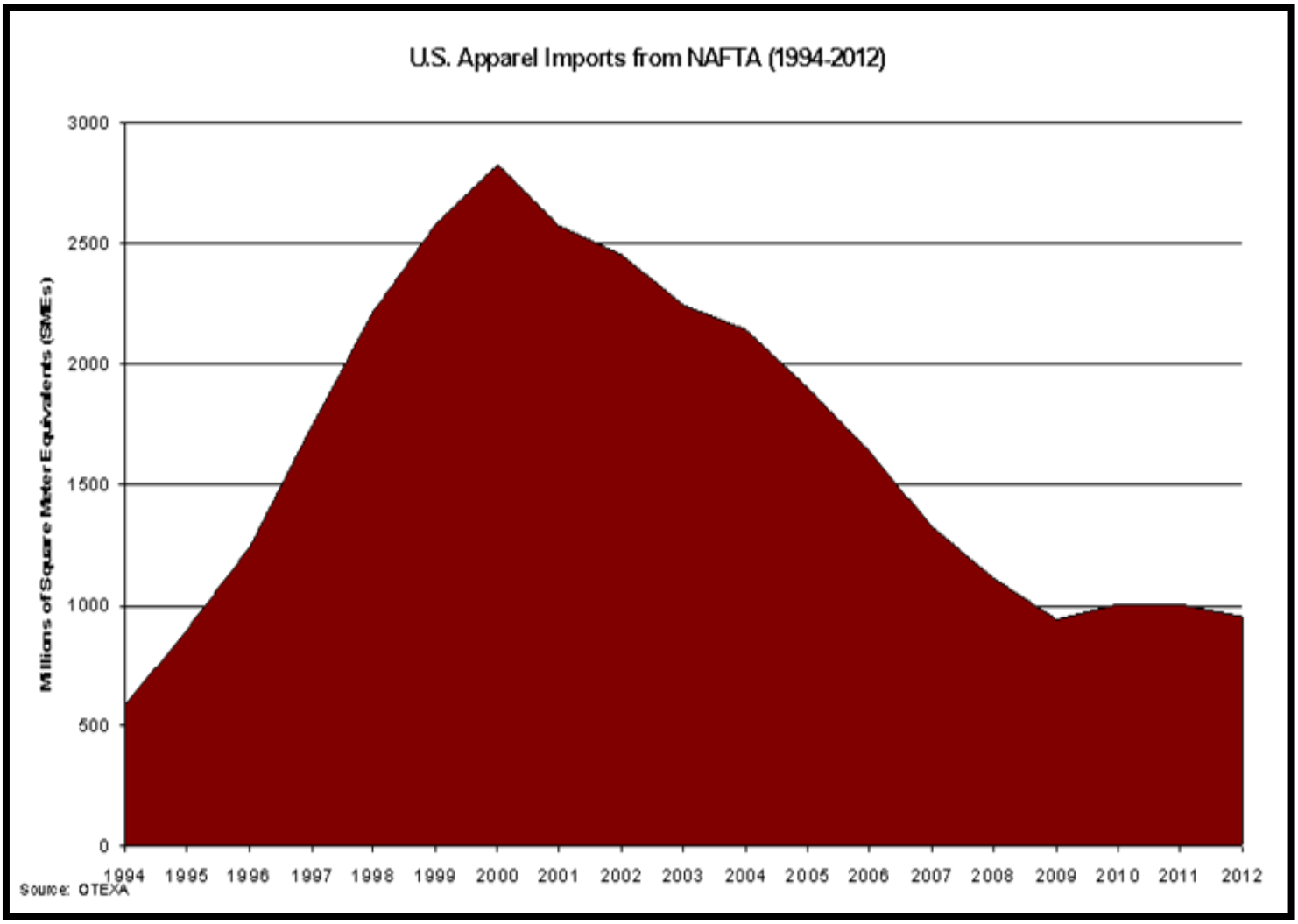
are more stringent than is required to avoid trade deflection. As a result, complying with the indicated rules of origin will require costly and/or complex operations to be taken, and hence entry to the markets protected by the imposition of restrictive rules of origin in preferential trade agreements will be shackled with respect to the targeted competing products trying to enter them under the preferential trade agreement preferences.[81] Although the stringency of the triple transformation rule could help in deterring trade deflection, its level is a good deal more than that needed to avoid the deflection. There are other, less stringent alternatives that could be used to fulfill the same aim. For example, teasing the cotton, spinning it, weaving the yarns, fabricating the fabrics, adorning the goods and all clothing production processes can be simply checked by officially surveying the textiles production firms and scrutinizing their stocktaking books, package deals and demands.[82] Consequently, these checking operations could be carried out and the triple transformation rule of origin could be simplified. Thus, using the triple transformation rule as a disguised protectionist device is the only reason that explains why the US and its other NAFTA parties, presumably prefer applying it, although other suitable options could be used to avoid the trade deflection.

The US officials during the formation of the NAFTA recognized that that triple transformation rule of origin would cause the textile producers in the North American region to source materials from the US instead of Asia.[83] Apparently, this change might have worked out during the first couple of years subsequent to the

[81] Paul Brenton, 'Enhancing Trade Preferences for LDCs: Reducing the Restrictiveness of Rules of Origin' (n 37) 281-287.
[82] Aaditya Mattoo, Devesh Roy and Arvind Subramanian, 'The Africa Growth and Opportunity Act and its Rules of Origin: Generosity Undermined' (2002) World Bank Policy Research Working Paper 2908, 7.
[83] M. Angeles Villarreal and Ian F. Fergusson, 'NAFTA at 20: Overview and Trade Effects' (2014) Congressional Report Service 7-5700, 4 <http://fas.org/sgp/crs/row/R42965.pdf> accessed 17 December 2014.

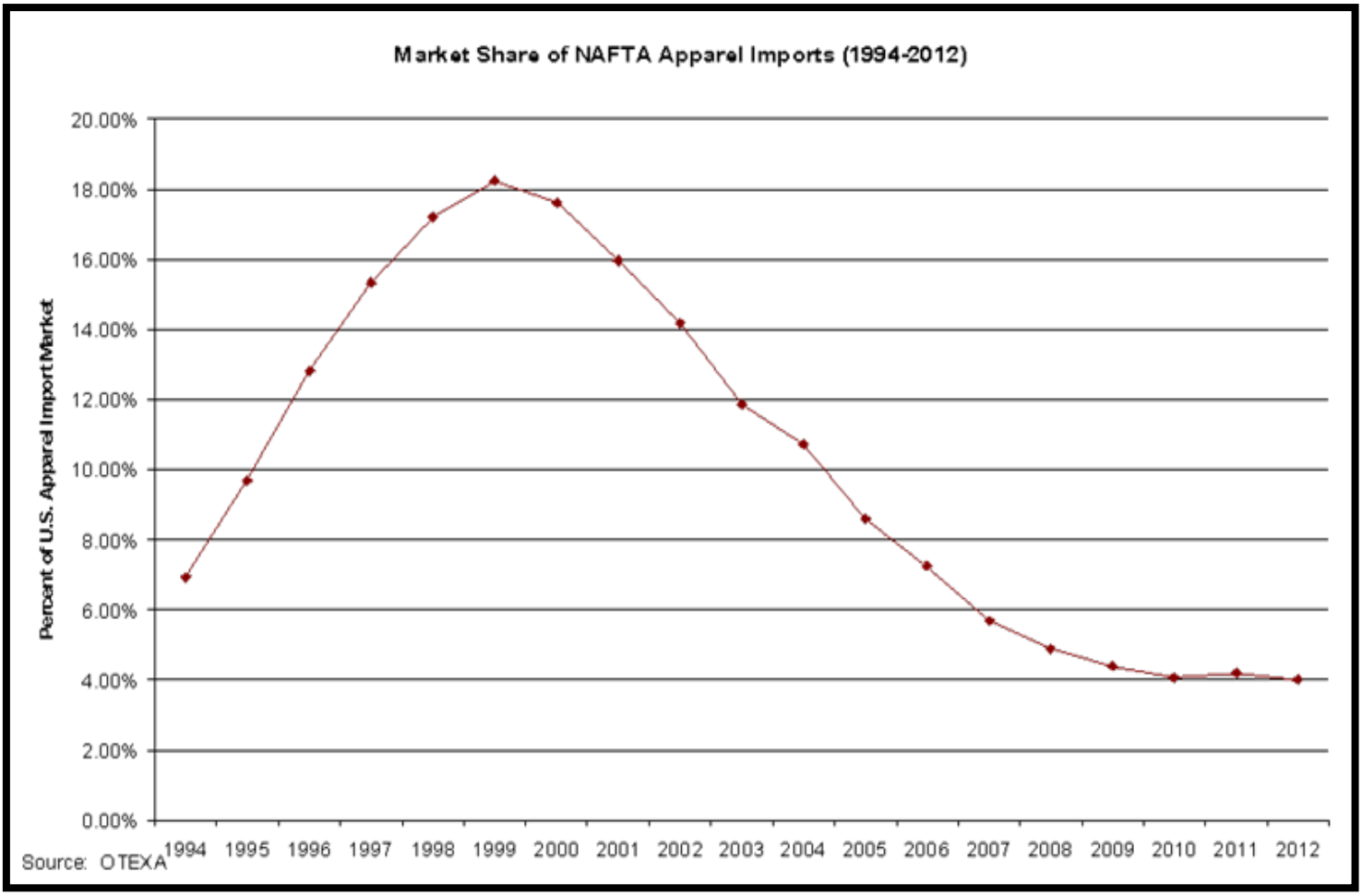
formation of the NAFTA. However, complying with the triple transformation rule of origin is costly, which does not guarantee the growth of trade between the NAFTA parties in the textile and apparel sector in the long run. According to the American Apparel & Footwear Association, the stringency of the imposed NAFTA triple transformation rule led to a decline that in the value of the apparel products exported to the US under the NAFTA and a decline in the market share of the NAFTA apparel imports beginning from 2000 until 2012, as shown in the diagrams below. The result is not trade-encouraging in the textile sector. The Association illustrated that even though trade between the US and its NAFTA partners increased until 2000 in the apparel sector, the triple transformation rule of origin is outdated, made the apparel imports and exports under the NAFTA suffer and no one can "negotiate 21st century trade deals using 20th century tools".[84]

[84] Steve Lamar, 'NAFTA at 20' (2013) the Government Relations Team, American Apparel & Footwear Association <https://www.wewear.org/politicaltrends/nafta-at-20/> accessed 5 January 2015.



Source: American Apparel & Footwear Association (2013).[85]

[85] Ibid.



Source: American Apparel & Footwear Association (2013)[86]

According to the mentioned, unless flexible NAFTA rules of origin are going to be imposed on textiles, it is likely that the market share of NAFTA apparel imports will continue to decline. Hence, the imposition of flexible NAFTA rules of origin on textile products is needed in order to increase the intra-NAFTA trade in textiles.

2.1.3 The EU GSP Rules of Origin.

The EU successfully harmonized and simplified its GSP rules of origin in 2010 (explained later in Chapter III), but this happened because its GSP rules of

[86] Ibid.

origin were criticized by many for being used for protectionist purposes.[87] This section shows *the status quo ante* of the protectionist implementation of preferential rules of origin in the EU GSP regime.

Although developing countries usually lack the employment of advanced operations when it comes to producing goods, they are characterized by inexpensive labour outlays needed during production processes. That is why they benefit, for example, from the textile production since excessive expenditure and/or advanced operations are unnecessary to set up an enterprise in that industry.[88] This benefit could be nullified if a preference-granting country attempts to protect its domestic textiles by imposing too stringent rules of origin on the competing textile products of developing countries trying to enter the market of the former under accorded preferences. Consequently, complying with such rules of origin might require costly and complex operations to be taken by the developing country which would prevent it from profiting from the accorded preferences and make it exceedingly difficult for its textiles to compete in the market of the preference-granting country. Thus, the developing country might not take advantage of the preferences and instead choose to trade with the preference-granting country on a MFN basis since this would not require it to make the costly and the complex operations necessary for the preferential rules of origin. This would lead to a low utilization rate of preferences.

The EU has endeavored to harmonize its various applicable preferential rules of origin. In 1999, the EU tried to achieve this by applying a single set of product-

[87] New Customs Rules Allow Developing Countries More Benefits from Trade with the EU [2010] European Commission Press Release IP/10/1526, 1<http://europa.eu/rapid/press-release_IP-10-1526_en.htm?locale=en> accessed 24 November 2014. See also Questions and Answers - Reform of GSP Rules of Origin [2010] European Commission Press Release MEMO/10/588, 1 <http://europa.eu/rapid/press-release_MEMO-10-588_en.htm?locale=en>> accessed 24 November 2014. See also Paul Brenton, Frank Flatters and Paul Kalenga, 'Rules of Origin and SADC: the Case for Change in the Mid Term Review of the Trade Protocol' (2005) Africa Region Working Paper Series 83, 5.

[88] Brenton 'Enhancing Trade Preferences for LDCs: Reducing the Restrictiveness of Rules of Origin' (n 37) 283.

specific rules of origin, referred to as the single list of product-specific rules of origin.[89] In July 2000, the EU applied this list to its GSP regime.[90] Consequently, the single list was also applied in the Everything But Arms Agreement since the latter is part of the EU GSP regime.[91]

The EU single list of product-specific rules of origin imposed the double transformation[92] requirement on clothing products categorized under chapters sixty-one and sixty-two (clothing products) of the HS.[93] According to this requirement, yarns could be obtained domestically or imported from anywhere in the world. However, the yarns are required to be woven into fabrics in the preference-benefiting country in which the fabrics are then to be fabricated into apparels qualified to be exported to the EU under the preferences given.[94] As a result, the imposed double transformation concept prohibited many beneficiary developing countries from importing fabrics needed for the production of the textiles intended for export to the EU under the preferences granted. Specifically, the utilization of only domestic fabrics, EU fabrics (because of the bilateral cumulation done with the EU) or fabrics imported from the allowed regional cumulation zones was allowed.[95] For the

[89] Commission Regulation (EC) No 46/1999 amending Regulation (EEC) No 2454/93 laying down provisions for the implementation of Council Regulation (EEC) No 2913/92 establishing the Community Customs Code' [1999] OJ L010/1.
[90] Alberto Portugal-Perez, 'The Costs of Rules of Origin in Apparel: African Preferential Exports to the United States and the European Union' (2008) Policy Issues in International Trade and Commodities, Study Series 39.
[91] The EBA initiative is part of the GSP regime where the same rules apply to both of them. The EBA grants the fifty least developed countries special preferential treatments more than that accorded to the developing countries of the normal EU GSP regime. See European Trade Commission, 'Everything but Arms (EBA) – Who Benefits?' <http://trade.ec.europa.eu/doclib/docs/2013/april/tradoc_150983.pdf> accessed 17 August 2014; European Commission, 'Taxation and Customs Union' <http://ec.europa.eu/taxation_customs/customs/customs_duties/rules_origin/preferential/article_781_en.htm> accessed 10 January 2015.
[92] It is known also by other terms: two-stage transformation, two-step conversion, multiple processing, two-stage conversion, fabric forward, or multiple transformations.
[93] Perez (n 90) 4.
[94] Ibid 3-4.
[95] The concept of cumulation is explained in Chapter III. Please see European Commission, 'Taxation and Customs Union' <http://ec.europa.eu/taxation_customs/customs/customs_duties/rules_origin/preferential/article_779_en.htm> accessed 17 August, 2014.

beneficiary countries to rely on the importation of fabrics for their textile production from the EU is costly.[96]

Exceptions to the double transformation requirement were provided in chapter sixty-two for some non-crocheted garments, where a less restrictive value content rule could to be applied as a substitute for the double transformation process.[97]

The EU single list of product-specific rules of origin was characterized by its complexity, in which the change in tariff classification method, mostly at the heading level of the HS, mixed with the value content and specific manufacturing operation approaches was applicable to a diversity of products.[98] The intricacy of the EU single list of product-specific rules of origin along with its double transformation requirement prevented many developing countries from benefiting from the EU GSP regime since they did not usually have the appropriate production capacity needed to comply with stringent rules of origin and since they relied, in most cases, on the utilization of imported materials when it came to production.[99]

Sri Lanka is one of the developing countries that could not profit much from the EU GSP regime with regard to its textiles and apparels exports. More than that, Sri Lanka's average use of the preferences accorded to it under the EU GSP regime is poor with respect to "foodstuffs, beverages, and machinery & electrical equipment" because of its inability to comply with the imposed EU GSP rules of origin.[100]

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[96] Janaka Wijayasiri, 'Utilization of Preferential Trade Arrangements: Sri Lanka's Experience with the EU and US GSP Scheme' (2007) Asia-Pac Research & Training Network on Trade, Working Paper Series 29, 34.

[97] Further information about the single list of product specific rules of origin is available at UNCTAD, 'Generalized System of Preferences: Handbook on the Rules of Origin of the European Union' (2013) UNCTAD/ITCD/TSB/Misc.25/Rev.3/Add.1.
<http://unctad.org/en/PublicationsLibrary/itcdtsbmisc25rev3add1_en.pdf> accessed 17 August 2014

[98] Estevadeordal, Harris and Suominen, 'Multilateralising Preferential Rules of Origin' (n 49) 9.

[99] Munir Ahmad, 'Impact of Origin Rules for Textiles and Clothing on Developing Countries' (2007) ICTSD Programme on Competitiveness and Sustainable Development, International Centre for Trade and Sustainable Development, Issue Paper 3, Geneva, 32.

[100] Wijayasiri (n 96) 35.

In response to the Tsunami crisis, the EU in 2005 granted Sri Lanka benefits, under the GSP+ system, more than those given through the ordinary EU GSP regime at which duty-free access to the EU was guaranteed for 7,200 Sri Lankan products.[101] Unfortunately, Sri Lanka could not benefit from the GSP+ regime concerning its textiles and apparels exports due to the stringency of the EU imposed double transformation rule of origin, because Sri Lanka relies mainly on imported yarns and fabrics when it comes to producing textiles.[102] The fabrics that Sri Lanka sourced from the EU (i.e. from the preferential trade area) to produce textiles constituted only 11% of Sri Lanka's fabric imports. The remaining 89% came from outside the preferential trade area as follows: South Asian Association for Regional Cooperation (SAARC) fabrics constituted 12% of Sri Lanka's total fabric imports, ASEAN fabrics constituted 6% and fabrics imported from further zones constituted 71%, in 2007.[103]

China is considered to be one of reasons why the EU imposed stringent rules of origin in its GSP regime.[104] It is regarded as a rival materials provider.[105] Many developing countries enrolled in the EU GSP regime source fabrics from China.[106]Because of the geographical location of many developing Asian countries near China, these developing countries could easily source low-priced and fine fabrics from China and use them in producing textiles. However, for the sake of countering competition from China, the EU imposed the stringent double transformation rule of origin in its GSP regime to prevent the Chinese fabrics from entering its markets

[101] Asian Development Bank (n 70) 18.
[102] Ibid. See also, Ratnakar Adhikari and Chatrini Weeratunge, 'Textiles & Clothing Sector in South Asia: Coping with Post-quota Challenges' (2006) 2 *South Asian Yearbook of Trade and Development - New Delhi: Academic Foundation* 109-145, 109.
[103] The figures are for 2007. Wijayasiri (n 96) 34-35.
[104] It should be made clear, however, that the EU rules of origin were not motivated by a desire to combat trade deflection.
[105]South Asia Watch on Trade, Economics and Environment, 'Salvaging the Doha Round' (2004) <http://www.sawtee.org/pdf/publication/tdm8.pdf> accessed 15 June 2013.
[106] UNCTAD, 'Trade Preferences for LDCs: An Early Assessment of Benefits and Possible Improvements' (2003) UNCTAD/ITCD/TSB/2003/8, 67.

under preferences when used in the textiles of the beneficiary Asian developing countries and to induce the textile producers of the latter to source materials from the EU (or elsewhere among GSP countries), rather than from more efficient Chinese sources of supply.[107]

The inability of many developing countries to comply with the EU's GSP rules of origin was manifested in the low utilization of their preferences under the EU GSP regime. Many developing Asian countries, such as Laos, Bangladesh, Nepal, Cambodia, India, Sri Lanka, Vietnam and the Philippines could not take much advantage of the EU GSP system. The mean rate of utilizing the preferences of these countries under EU GSP regime for chapters 61 and 62 of the HS was low. According to the Swedish National Board of Trade, the utilization rate of developing countries to the preferences granted to them under the EU GSP regime was the lowest in the textile and clothing sector when compared to other sectors as of 2012. [108]

Mahbubur Rahman, the president of the International Chamber of Commerce-Bangladesh, clarified that the rules of origin in the EU GSP regime did not help the least developed countries to take advantage of the preferences accorded to them under the latter regime. He argued that substituting the EU stringent rules of origin with simpler ones would "open an important window of opportunities for least developed countries like Bangladesh"[109]

It is obvious that developing countries need to make use of the preferences accorded to them by any preference-granting country. This need sometimes leads a beneficiary country to commit fraud, for example falsifying an origin certificate in

[107] Paul Brenton and Miriam Manchin, 'Making EU Trade Agreements Work: The Role of Rules of Origin' (2002) Centre for Eur. Pol'y Studies Working Paper 183, 13.
[108] Kommerskollegium National Board of Trade, 'The EU's and the US's Preferential Arrangements – a Comparison' [2012] 3.
[109] The Daily Star, 'Product Diversification Key to Utilizing EU Market Access Facility' (2006) <http://archive.thedailystar.net/2006/02/24/d60224050145.htm> accessed 15 August 2014.

order to comply with a stringent rule of origin of a unilateral trade regime, and thus illegally benefit through the preferences given to it under the regime. The Bangladesh T-shirts case is a good example of this.[110]

In March 1995, some EU customs authorities noticed a marked increase of T-shirts imported from Bangladesh. They decided to request the Department of Trade and Industry to check the validity of the T-shirts' origin certificates. The EU member countries, the EU Commission, and EU customs authorities conducted an inspection concerning the issue. According to the results, 10,000 origin certificates were falsified. Consequently, a fine and customs duties on all T-shirts that were exported to the EU covered by the falsified origin certificates were paid to the EU. In 1997, total compliance with the EU rules of origin became a condition to issue origin certificates (form A)[111] for textiles and apparel products exported from Bangladesh to the EU. This caused a sharp drop in Bangladesh's utilization of preferences under the EU GSP scheme to below 30% from 1997 to 1998.[112]

What can be learned from the Bangladesh T-shirts case is that developing countries are in need of any preferences accorded to them. If stringent rules of origin are going to be imposed to prevent them from competing, improving, and thus utilizing the preferences, circumventing these rules, dealing with them as if they did not exist, could take place. As a result, there would be more international trade disputes. Some countries would win those cases and others would lose, so why bother

[110] UNCTAD 'Trade Preferences for LDCs: An Early Assessment of Benefits and Possible Improvements' (n 106) 62.

[111] Form A is a GSP origin certificate. Form A certificates are brought out for only commodities that are produced in accordance with the rules of origin. Moreover, such commodities shall be produced by plants registered in the Department of Trade and Industry. More information about the Form A origin certificate and a sample is *available at* Trade and Industry Department, 'How to Apply for a Certificate of Origin Form A' (2005) the Government of the Hong Kong Special Administrative Region <http://www.tid.gov.hk/english/aboutus/publications/registcert/files/forma.pdf> accessed 17 August 2014.

[112] For more details about the case, See UNCTAD 'Trade Preferences for LDCs: An Early Assessment of Benefits and Possible Improvements' (n 106) 62.

in the first place with imposing stringent rules of origin? Why do countries give preferential trading terms and then largely negate the advantage they bring by imposing restrictive rules of origin? Some countries impose restrictive rules of origin to make such rules act as alternative trade barriers (restricting the duty-free access) and protectionist instruments. Imposing stringent rules of origin in a GSP regime could undermine the ability of the beneficiary developing countries to take advantage of, or utilize, the accorded preferences. Alternatively, the beneficiaries might choose an alternative to forbear the granted preference and trade with the preference-granting country on MFN grounds, rather than trying to comply with the preferential rules of origin.[113] Of course, this assumes that the non-preferential rules of origin would be less strict.

Before imposing any GSP rules of origin in unilateral trade regimes, the preference-granting country should first gather statistics and information related to the production capability of the preference-given country, i.e., the amount of imported inputs needed for production, local resources and production firms. Pursuant to such gathered statistics, a single list of rules of origin which meets the collective needs of the least developed countries should be imposed. Otherwise, complying with the rules of origin would be difficult and would need production operations that could not be undertaken easily by the beneficiary country since the latter would not have the sufficient supplies needed for production in accordance with the imposed rules of origin, leading to its inability to benefit from/utilize the preferences accorded to it under the unilateral regime. The only explanation that explains why a preference-granting country would not want to gather the mentioned statistics and accordingly apply appropriate rules of origin to a beneficiary country is because it wishes to use

[113] Wijayasiri (n 96) 5.

rules of origin as protectionist apparatuses, i.e., to protect its susceptible products and national interests.

In 2003, the EU Commission published the green paper, COM (2003) 787 final, that evaluates the application of its rules of origin in preferential agreements, especially those with developing countries.[114] The green paper explained that the role of the EU preferential rules of origin was to help in opening up the EU market for imports from partner countries, but in a way that afforded "protection for the EU interests concerned". Also, the green paper explained that this policy is moving towards a general drive to "access for EU exports to third country markets".[115] Moreover, the green paper illustrated that the insufficiency of manufacturing firms, investment opportunities or managerial systems in the beneficiary developing countries, along with the inability of traders there to comprehend the complex imposed EU rules of origin, made it arduous for the beneficiary developing countries to comply with EU rules of origin and, consequently, benefit much from the preferences accorded to them by the EU.[116] Furthermore, the summary report of the results of the consultation process on the green paper made clear that the EU GSP rules of origin did not take into account the conditions of actual market, trade, industry and agriculture. Also, the report criticized the EU GSP rules of origin by arguing that they reflected "past defensive policy aims" and were employed too often "as defensive trade instruments".[117]

[114] Commission, 'The Future of Rule of Origin in Preferential Trade Arrangements' (Green Paper) COM (2003) 787 final.
[115] Ibid, 7. The Green Paper does not identify what these 'interests concerned' are.
[116] Ibid, 7-8.
[117] Commission, 'A Summary Report of the Results of the Consultation Process on the Green Paper the Future of Rule of Origin in Preferential Trade Arrangements' (2004), 4 and 7 <http://ec.europa.eu/taxation_customs/resources/documents/origin_consultation_final.pdf> accessed 13 January 2015.

Having the EU admitting clearly using preferential rules of origin to make access for its exports to third country markets, the complexity of its GSP rules of origin, the use of preferential rules of origin as alternative trade barriers, instead of using them to implement trade policy instruments, reflected the protectionist intention of the EU, which is exactly what Bhagwati described as the law of constant protection, as mentioned in Chapter 1. 4.

Following on from the green paper, in March 2005, the EU adopted a communication characterized by its view to simplify and relax its preferential rules of origin and to use the value content method as the main origin determination criterion in the Economic Partnership Agreements and, in particular, the GSP regime. [118]

2.1.4 What should be done to Combat Protectionist Rules of Origin?

> "The contracting parties recognize the desirability of increasing freedom of trade . . . through voluntary agreements . . . [T]he purpose of a customs union or of a free-trade area should be to facilitate trade between the constituent territories . . . ."[119]

According to this Article of the GATT, trade facilitation shall arise between the contracting parties to any preferential trade agreement. Otherwise, the formation of a preferential trade area will be pointless and useless. Accordingly, if stringent rules of origin (not necessarily excessively strict or stringent) were implemented in a

[118] Commission, 'Rules of Origin in Preferential Trade Arrangements: Orientations for the Future' (Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee) COM (2005) 100 final, 4.
[119] General Agreement on Tariffs and Trade (30 October 1947) 55 UNTS 187, provisionally entered into force on 1 January 1948 (superseded by GATT 1994), art XXIV (4).

preferential trade agreement, trade could be hindered and, consequently, the trade facilitation purpose mentioned in Article XXIV (4) of the GATT would not be accomplished.

As seen above, the employment of rules of origin as protectionist devices exists in a number of trade regimes. As a result of establishing various preferential contractual and/or autonomous trade regimes and lowering MFN tariffs in general, trade barriers have been reduced or eliminated. Consequently, countries started to use rules of origin as alternative barriers to trade in order to protect their own national interests and susceptible goods.[120] Preferential rules of origin can continue to be used as protectionist apparatuses so long as they are not harmonized.

The applications of rules of origin that suit the interests and protect the susceptible goods of the countries that designed them reflects the usage of the rules as protectionist devices. This makes things complex for traders and producers all over the world in that it: (1) increases the number of international trade disputes; (2) reduces the utilization of preferences in preferential trade areas; and (3) undermines global competition. As a direct result, consumers worldwide are left with fewer choices and international trade (intra-preferential trade area and trade with third countries) is hindered. These unintended consequences go against many principles of the GATT and the WTO Agreement on rules of origin.

Based on the previous analysis and clarifications, the following solutions are suggested in order to prevent the application of any protectionist rule of origin:

- Calculating the production capability of contracting parties to preferential trade agreements, by gathering statistics and information about their

[120] The term "trade objectives," mentioned in Article 2(b) of the Agreement on Rules of Origin, refers to the prohibition of member countries using rules of origin as a protectionist tool. See Moshe Hirsch, 'Rules of Origin as Instruments of Foreign and Domestic Policies' (2008) Hebrew University of Jerusalem, Faculty of Law, 16.

established capacities and by knowing to what range they use such capacities; and then adopting rules of origin accordingly;

- Or the harmonization of preferential rules of origin, provided the harmonization model is having straight forward rules of origin, which are obviously non-protectionist.

Complying with the second suggested solution is the most efficient way to avoid the issue of using rules of origin as protectionist instruments. Doing so would: (1) cease the freedom of countries to use rules of origin in a disguised way to protect their own national interests and susceptible goods; (2) ensure the objectivity, predictability and transparency of rules of origin; (3) eliminate the variation in such rules across agreements and countries; (4) reduce the number of international trade disputes; (5) increase the utilization proportions of preferences in preferential trade areas; (6) foster a global environment of fair competition; and (7) provide consumers all over the world with greater choice. As a result, international trade would be facilitated and welfare would spread worldwide. Under this strategy, the fundamental aims of the GATT and the WTO Agreement on Rules of Origin would successfully be realized without those agreements being breached. The prospects for achieving such harmonization of both preferential and non-preferential rules of origin are discussed in Chapter IV.

2.2 Rules of Origin as Triggers to Trade Diversion.

"[T]he higher the threshold established in the rules of origin, the greater the chance that trade diversion will take place."[121]

"Trade creates jobs and lifts people out of poverty";[122] but this raises the question: how is trade created? Trade Creation is a technical term. According to Viner, trade creation a situation that could take place when the elimination of external tariffs between the member countries of a preferential trade area shifts the demand for goods from domestic producers to more efficient producers in another member country of the preferential trade area, leading to an increase in the trade flow between the member countries above previous levels, contrary to the situation before the formation of the preferential trade area.[123] Trade creation boosts welfare within preferential trade areas once it takes place subsequent to their formation. That is why if a large number of countries become members of a FTA or a CU, there will be a greater chance for the existence of cheap inputs producers within the preferential trade area, leading to trade creation to some extent within the preferential trade area.[124]

This section discusses how the misuse of preferential rules of origin could lead to trade diversion. Trade diversion is the opposite of trade creation. Sometimes the imposition of too stringent rules of origin in a FTA aims at making the internal final

[121] Anne O. Krueger, 'Free Trade Agreements as Protectionist Devices: Rules of Origin' in James R. Melvin, James C. Moore and Raymond Riezman (eds), *Trade, Theory, and Econometrics: Essays in Honor of John C. Chipman* (New York: Routledge 1999) 91-101 as cited in William H. Cooper, 'Free Trade Agreements: Impact on U.S. Trade and Implications for U.S. Trade Policy' (2014) Congressional Research Service 7-5700, 12.
[122] The attributed quote belongs to Dennis Hastert <http://www.brainyquote.com/quotes/authors/d/dennis_hastert_2.html> accessed 25 April 2013.
[123] Jacob Viner as quoted by Cooper (n 121) 8.
[124] C. Parr Rosson, C. Ford Runge and Kirby S. Moulton, 'Preferential Trading Arrangements: Gainers and Losers from Regional Trading Blocs' <http://www.ces.ncsu.edu/depts/agecon/trade/eight.html> accessed 25 April 2013.

good producer import costly inputs from within the free trade area rather than cheaper inputs from outside it, to produce a final product that complies with the FTA rules of origin and consequently becomes eligible for preferential treatment (duty-free access). Such alteration of inputs importation, from a cheap external source of supply (efficient) to a costly internal one (inefficient) is known as "trade diversion". Therefore, diverting trade to a costly internal inputs producer could lessen "the economic welfare"[125] of a FTA contracting party and the third countries that used to export inputs to the former before the formation of the FTA.[126] On the other hand, trade diversion affects "global efficiency", since it widens the "production" of inefficient internal "producers" and shrinks the production of efficient third countries producers.[127]

Trade diversion occurs not only because of the imposition of trade-diverting rules of origin in preferential trade areas. The formation of preferential trade agreements in general could lead to trade diversion as well. The following sub-section explains how.

[125] Cooper (n 121) 8.
[126] Unless the FTA contracting party decides to forgo the preferential preferences and trade within the preferential trade area on MFN grounds, to maintain its importation of inputs from the efficient external supplier.
[127] Robert Z. Lawrence (n 41) 52; See also Asian Development Bank (n 68) 52.

2.2.1 The Possible Trade-Diverting Consequences of Preferential Trade Agreements.

If rules of origin are not imposed in a FTA, the export of products to the free trade area from third countries will be directed mainly to the member country with the lowest external tariff.[128]

According to Viner,[129] although the liberalization of tariffs among the member countries of a preferential trade area expands trade between them by encouraging sourcing the goods from inside the area, it diverts trade from an external cheap source of supply to an internal expensive one.[130] Such diversion happens because following the formation of a preferential trade agreement, the tariff liberalization among the preferential trade agreement members makes the internal trade less expensive than trade with third countries external and gives the internal sources of supply "a price advantage".[131]

The next two figures illustrate how trade diversion could take place as a result of forming a preferential trade agreement.

Using three hypothetical countries: A, B and C, the figures show how trade relationships between a FTA contracting party and an external source of supply may differ before and subsequent to the formation of the FTA. It is to be noted that the following discussion does not include in the figures the need for producers to make a profit because whoever the producer is in Country A, B or C, he will need to make a profit, so in principle it is neutral as between the two scenarios.

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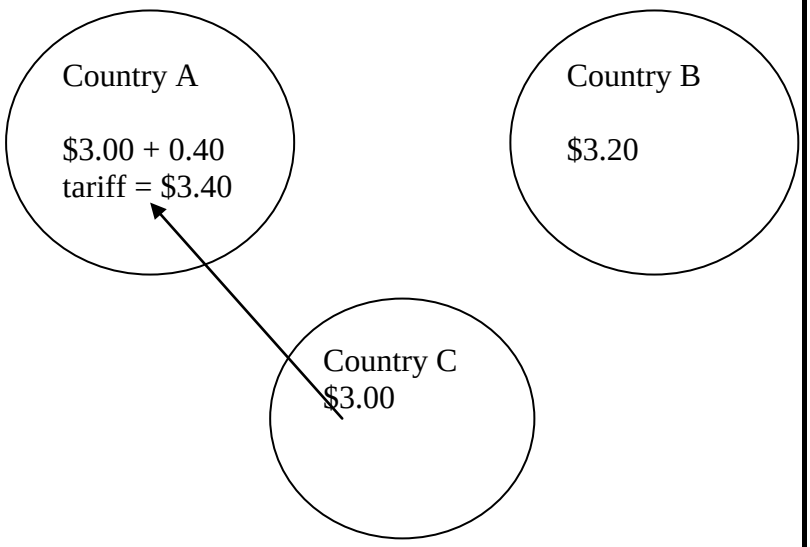
[128] Duttagupta and Panagariya (n 73) 17.
[129] Jacob Viner, *The Customs Issue* (Carnegie Endowment for International Peace, 1950).
[130] Duttagupta and Panagariya (n 73) 9-10.
[131] For an example illustrating such point, see Robert Z. Lawrence, *Regionalism, Multilateralism and Deeper Integration* (The Brookings Institution, Washington DC, 1996) 24-25.

Suppose that before a FTA is formed between countries A and B, the importers in country A used to import a product (say X) costing $3.00 from country C at a price of $3.40 after paying a $0.40 external MFN tariff. Suppose also, on the other hand, that the price of producing product X in country B is $3.20. The import of product X from country B, at a price of $3.60 (including the $0.40 tariff payable), would be more costly for country A's importers than importing it from country C, ignoring transport costs, insurance, etc.

Before forming a FTA between country A and B

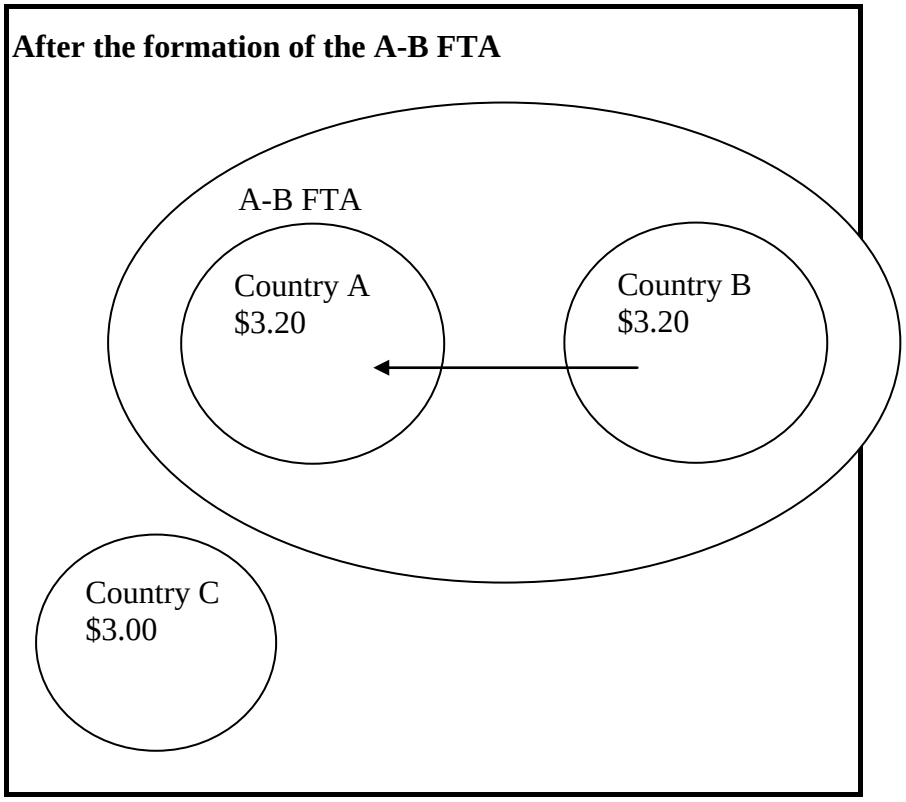


P.s. the arrow in this phase and the next one stands for an exportation of product X to Country A.

Source: Author's analysis.

Once a FTA between countries A and B (A-B FTA) is formed, and customs duties removed, the importers of country A would source X from country B under preferences—at a price of $3.20—more cheaply than they would source it from country C—at the price of $3.40. Thus, forming the A-B FTA will divert the trade in X from a formerly cheap source of supply in country C (producing X locally at the

price of $3.00) to a costly one in country B (producing X locally at the price of $3.20). Hence, trade diversion can be observed by studying with which countries each contracting party to a preferential trade agreement is and was practicing trade in goods, prior and subsequent to the formation of the agreement.[132]



Source: Author's analysis.

For example, the United Kingdom (UK) used to import cheap lamb from New Zealand.[133] However, when the UK became a member country of the EU, it began to source lamb from a costly lamb internal supplier—France—because the EU common external tariff made the importation of lamb from New Zealand "more expensive" than the lamb from France.[134] The external tariff here was quite definitely and

[132] Petros C Mavroidis, 'If I Don't Do It, Somebody Else Will (or won't): Testing the Compliance of Preferential Trade Agreements with the Multilateral Rules' (2006) 40 *Journal of World Trade* 187, 191.
[133] Philip Whyte, *Narrowing the Atlantic: The Way Forward for EU-US Trade and Investment* (Centre for European Reform, London 2009).
[134] Ibid 23-24.

explicitly used for protectionist purposes: protecting French (and EU) lamb producers against competition from cheaper imported lamb from New Zealand.[135] That is why there is a relationship between protectionism and trade diversion (discussed later in this chapter).

2.2.2 The Trade-Diverting Consequences of Preferential Trade Agreements Rules of Origin.

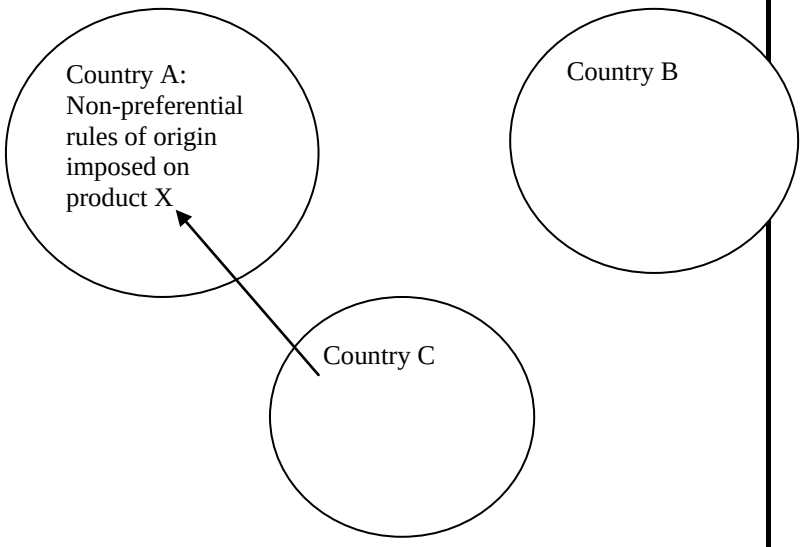
As explained, in preferential trade regimes, trade diversion sometimes takes place as a result of the imposition of trade barriers, such as a country's "external tariffs"[136]. However, trade diversion can also happen because of the imposition of stringent preferential rules of origin.

One must differentiate between rules of origin applied to goods traded between a free trade area member countries and rules of origin applied to imports coming from third countries. The former are those preferential rules that all of the free trade area members agree to comply with as a condition to benefit from the preferential treatment when exporting goods to each other. Therefore, the FTA rules of origin do not apply to imports coming from countries that are not contracting parties to the FTA (third countries). When an exporter from a third country decides to export goods to any member of a free trade area, it would have to comply with the non-preferential rules of origin imposed by any member of the free trade area.

[135] Agustin Carstens, 'Making Regional Economic Integration Work' (2005) Speech at the 20th Annual General Meeting and Conference of the Pakistan Society of Development Economists <http://www.imf.org/external/np/speeches/2005/011205.htm> accessed 23 April 2014. Carstens mentions that countries may impose high external MFN tariffs for protectionist purposes.
[136] Anne O. Krueger, 'Free Trade Agreements as Protectionist Devices: Rules of Origin' (1993) National Bureau of Economy Research working Paper 4352, 4.

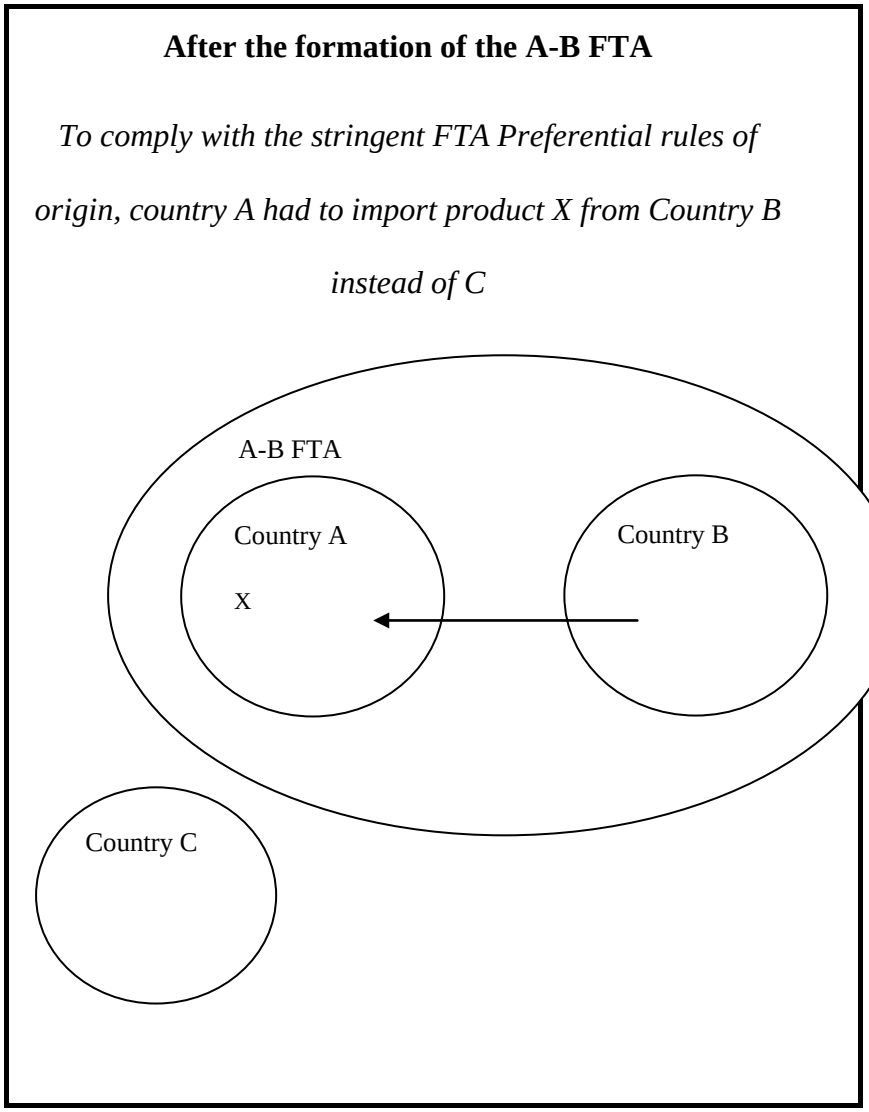
The formation of a FTA could result in trade diversion when the agreement imposes stringent rules of origin that would make an internal final good producer alters its importation of inputs from an efficient external inputs supplier to a less efficient internal one in order to comply with the FTA rules of origin and, consequently, benefit from FTA preferences. It is to be noted, though, that this applies only to FTAs and unilateral concessions. CUs are different because they impose common external tariffs. That is why, unlike FTAs and unilateral concessions, there is no need for preferential rules of origin within CUs, as clarified in Chapter I. Therefore, the trade diversion that may happen because of the imposition of stringent preferential rules of origin does not take place when it comes to the formation of CUs.

Before forming a FTA between country A and B



P.s. the arrow in this phase and the next one stands for the export of product X (input) to Country A, for the production of a final good there.

Source: Author's analysis.



Source: Author's analysis.

2.2.3 The Relation between the Imposition of Protectionist Rules of Origin and Trade Diversion.

The discussion in sub-section 2.1.2.2 of protectionism concerning ketchup is an example of an actual case of trade diversion, where the imposition of the stringent NAFTA rule of origin for ketchup aims at driving North American ketchup producers to source the needed tomato paste from *protected* Mexican tomato paste producers,

rather than from the more efficient paste producers of Chile.[137] This shows that there is a close relationship between using rules of origin as protectionist devices and the occurrence of trade diversion.

Since the imposition of a protectionist rule of origin in a preferential trade regimes endeavors to protect an internal inputs supplier from competing with a more efficient external supplier by causing a shift in the importation of inputs to the former from the latter, all protectionist preferential rules of origin are trade-diverting, and thus negatively affect global efficiency. Many examples other than the mentioned ketchup rule of origin clarify the relationship between the imposition of stringent, protectionist rules of origin and the occurrence of trade diversion. The following subparts illustrate additional examples.

2.2.4 North America vs. Asia.

A diversion to North American sources of materials used in the textile industry, following the formation of the NAFTA, from efficient Asian suppliers[138] to Mexico took place, which led to a reduction in Chinese and Indian materials exports to the US and Canada.[139] This happened because under the NAFTA rules of origin "unless natural fibres were imported", the triple transformation rule imposed in the textile sector prevented the usage of cheap components from East Asia for the production of "NAFTA originating textiles".

[137] Brenton and Manchin (n 107) 28.
[138] Daniel Lederman, William F. Maloney, and Luis Serven, *Lessons from NAFTA for Latin American and Caribbean (LAC) Countries: A Summary of Research Findings* (Palo Alto, Calif.: Stanford University Press, 2004) 12.
[139] Inama (n 72) 278.

Preventing the use of East Asian components may have encouraged the establishment of a "capital-intensive" industry in Mexico, leading to a reduction in the NAFTA trade creation.[140] Consequently, Mexico acquired a considerable market share in both Canada and the US concerning its textile exports to their markets.[141] This illustrates the role of the triple transformation rule in protecting North American materials producers and diverting trade to them from the competitive Asians.

A lot of Asian countries have declared in the late 1990s that the NAFTA stringent rules of origin imposed on the textiles and automobiles sectors were causing trade diversion.[142] Subsequent to the formation of the NAFTA, the aggregate components for textile exports of Hong Kong, Korea and Taiwan to North America became less than that of Mexico to the rest of its NAFTA contracting parties.[143] According to the World Bank, the NAFTA rules of origin were accountable for the regional shift of clothing importation from the Asian countries to Mexico.[144]

The following chart compares the allocations of Mexico, Hong Kong, Korea and Taiwan total textiles exports in North America, prior and subsequent to the formation of the NAFTA until 2001. This shows that trade diversion did take place in

[140] "Potential US textiles companies wishing to relocate to Mexico have to invest greater amounts of capital in order to comply with NAFTA origin requirements, since to take advantage of labour costs and NAFTA preferential rates they have the following choices: (i) import US cotton yarn with loss of comparative advantage, or (ii) start the manufacturing process from imported natural fibres or to imports of fabrics from North America (i.e. increasing the trade diversion) or require Mexican and Canadian textiles producers to buy yarn from US textiles mills before being allowed to sell the clothing to US consumers duty-free. The combination of both the yarn forwarding rules and the high tariffs facing textile imports imply that the North American producers have an incentive to use US made fabrics rather than competitive fabrics from Asia." TradeMark Southern Africa (TMSA), 'Training Module on Rules of Origin' (2013) TMSA Module to complement the COMESA-EAC-SADC Tripartite market integration Initiative, 27 <http://pages.au.int/sites/default/files/Rules%20of%20Origin%20Training%20Module.pdf> accessed 13 August 2014.

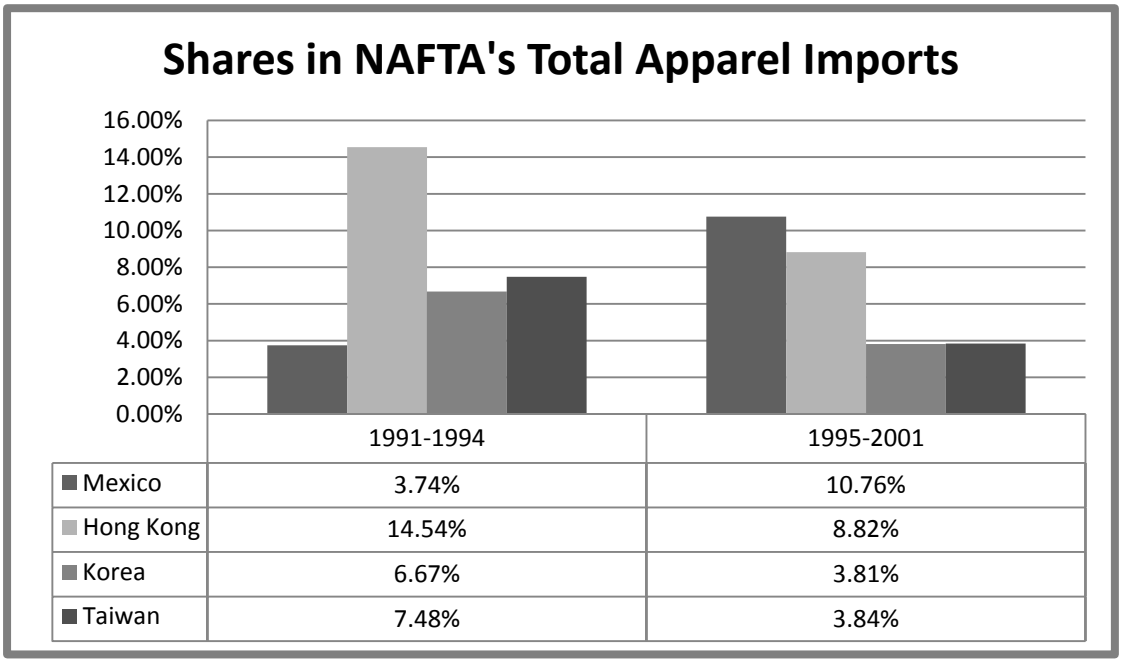
[141] T.N. Srinivasan, 'Preferential Trade Agreements with Special Reference to Asia' (2001) Paper presented at the Asian Economic Outlook Workshop, 9-10 <http://www.econ.yale.edu/~srinivas/PrefTradeAgreements.pdf> accessed 31 August 2014.

[142] George Holliday, 'Regional Trade Agreements: Implications for U.S. Trade Policy' (1997) Congressional Report Service 97-663 E, 13 <http://assets.opencrs.com/rpts/97-663_19971212.pdf> accessed 12 August 2014.

[143] Lederman, Maloney, and Serven (n 138) 326.

[144] Ibid 12.

the North American Free Trade Area because the total Mexican clothing exports to the region before the formation of the NAFTA were less than that of Hong Kong, Korea and Taiwan, and contrary to what the situation came to be after the formation of the agreement, where the overall Mexican clothing exports to the region became higher than that of its three aforementioned rivals.



	1991-1994	1995-2001
Mexico	3.74%	10.76%
Hong Kong	14.54%	8.82%
Korea	6.67%	3.81%
Taiwan	7.48%	3.84%

Source: Author's calculations based on Lederman, Maloney, and Serven (2004).[145]

2.2.5 The EU double transformation rule and trade diversion.

As explained in section 2.1, the double transformation rule of origin in the EU preferential trade agreements is aimed mainly at encouraging the internal textile producers in the countries parties to these agreements to source the materials they need from EU suppliers rather than from more efficient external providers, such as those of China. Thus according to Brenton and Manchin, producers in developing

[145] Ibid, 326.

partner countries, such as those under the EU GSP and those in the Balkans under the Central European Free Trade Agreement, have to import fabrics from the EU instead of cheaper ones from producers in countries as China to comply with the double transformation rule of origin and be granted the preferences, leading to trade diversion, and a reduction in the economic welfare of Balkan countries.[146]

2.2.6 The Negative Effects of Article XXIV of the GATT 1994.

As mentioned in Chapter I, subject to the fulfillment of certain conditions under Article XXIV of the GATT 1994, preferential trade agreements may be formed as a discriminatory exception to the MFN principle. Article XXIV of the GATT differentiates between two main forms of preferential trade agreements, CUs and FTAs. Article XXIV: 8 provides definitions for customs unions and free trade areas. Article XXIV:8 (a) (i) states that a customs union is a trading bloc that consists of two or more members in which, with certain exceptions, duties and restrictions of commerce are "eliminated with respect to substantially all the trade" between the members of the union. Article XXIV: 8 (a) (ii) clarifies that a customs union imposes a common external tariff and other regulations of commerce related to commerce with WTO members which are third countries to the union. Article XXIV: 8(b) provides the same requirements of Article XXIV: 8 (a) (i), but with respect to free trade areas.[147]

[146] Brenton and Manchin (n 107) 14-15.
[147] Mikella Hurley and Marina Murina, 'Designing a WTO-Consistent Customs Union: Select WTO Obligations in the Context of GATT Art. XXIV' (2011) Submitted to the Permanent Mission of the Russian Federation to the United Nations Office and other International Organizations in Geneva, Graduate Institute of International and Development Studies, 12.

Article XXIV: 4 provides that WTO member countries may form CUs or FTAs for the objective of facilitating trade between the constituent countries without raising barriers when it comes to trading with third countries.[148]

Article XXIV: 5 clarifies the conditions that shall be met to form a FTA or CU. Article XXIV: 5(a) and (b) illustrate that for preferential trade agreements to be formed, "the duties or other regulations of commerce" imposed at the formation of such agreements related to trade with third countries shall not on "the whole be higher or more restrictive" than those applied before the formation of the agreements.[149]

Article XXIV: 6 clarifies that if the formation a CU results in a member country increase its tariffs above the concession rate, Article XXVIII would be applied. This means that the WTO member countries would have to enter negotiations with other WTO members. The aim of such negotiations is to compensate those third countries[150] which found difficulties accessing the market of the CU member.[151]

ii. The Outcome:

Based on the arguments in the previous sub-sections, the formation of a preferential trade agreement could lead to trade diversion in two phases that could happen separately or together. The first phase takes place when the liberalization of tariffs among the preferential trade area member countries makes internal trade less expensive than external trade. This liberalization of tariffs and trade gives the internal suppliers special advantage that the outsider suppliers do not have. The second phase occurs when the preferential trade agreement imposes stringent rules of origin that divert the final good producer's importation of inputs from efficient external suppliers

[148] Van den Bossche and Werner Zdouc, *The Law and Policy of the World Trade Organization*, (3rd edition, CUP 2013) 696.
[149] Lorand Bartels, 'Interim agreements under Article XXIV GATT' (2009) 8 *World Trade Review* 339–350, 340
[150] WTO member countries that are not contracting parties to the CU.
[151] Petros Mavroidis, *Trade in Goods* (2nd edition OUP 2012) 212.

to inefficient internal ones, to satisfy the stringent preferential rules of origin and, thus, trade under preferences.

What is common between the first and the second phases is that both of them take place subsequent to the formation of a preferential trade agreement. However, trade diversion in both phases happens because of two different discriminatory causes. On one hand, the liberalization of tariffs among the preferential trade area member countries is what causes the diversion in the first phase and is discriminatory because the liberalization is provided to only the preferential trade area members and not to third countries. On the other hand, what cause the diversion in the second phase are the stringent rules of origin. Such rules are of a discriminatory nature because they are designed to favor internal suppliers of inputs at the expense of more efficient external ones.

The GATT MFN principle does allow WTO member countries to discriminate between different sources of supply[152]. However, the formation of preferential trade agreements under Article XXIV of the GATT and the principles of Annex II of the WTO Agreement on Rules of Origin do not lay down limits on the stringency level of the preferential rules of origin. The signatories of the GATT knew that the formation of preferential trade areas under article XXIV of the GATT went against the GATT MFN principle,[153] but they kept in mind that that formation and exception should

[152] Asian Development Bank (n 70) 9; in this paper it is clarified "[T]hat trade liberalization under the WTO should not involve any trade diversion, as MFN treatment implies nondiscrimination between sources of imports." See also Cooper (n 121) 10.

[153] It is to be noted that there is more than one exception to the MFN principle. The Enabling Clause of 1979 is another exception from which developing countries are allowed to be accorded preferences autonomously from the developed countries through the formation of a GSP.

bring "welfare" to the preferential trade agreements' contracting parties[154] by creating trade within the preferential trade areas and by avoiding trade diversion therein.[155]

The application of stringent trade-diverting preferential rules of origin in a preferential trade area makes the internal trade costly and complicated and obstructs trade with efficient third countries' producers that used to export inputs to the preferential trade area. Therefore, imposing trade-diverting rules of origin does not help in achieving the objectives of article XXIV (4) of the GATT 1994[156] because, pursuant to paragraph 4 of the Article, the formation of preferential trade areas "should be to facilitate trade between the constituent territories and *not to raise barriers to the trade of other contracting parties with such territories*."[157]

In summary, imposing stringent preferential rules of origin in preferential trade regimes, along with high external MFN tariffs, is a trade-isolating barricade that could divert trade, obstruct efficient external sources of supply, and undermine global efficiency.

2.3 The Use of Rules of Origin for Political Purposes.

In preferential trade agreements, rules of origin are sometimes imposed to pursue political objectives depending on the foreign policies of the contracting parties. However, rules of origin were mainly designed for origin determination purposes and, definitely, not political ones. Furthermore, granting originating status is related to

[154] Asian Development Bank (n 70) 5- 6.
[155] Cooper, (n 121) 10.
[156] Edwin Vermulst, 'Keynote Speech for the ADB Intensive Course on Rules of Origin'(2004) Intensive Course on Rules of Origin, 16 <http://www.adb.org/Documents/Events/2004/Intensive-Rules-Origin/text-vermulst.pdf> accessed 10 July 2013.
[157] General Agreement on Tariffs and Trade 1994 (n 119) Article XXIV (4) (emphasis added).

"territorial disputes" because rules of origin are mainly employed to determine the territorial origin of the product. As a result, origin could be conferred to a territory that is not covered by a preferential trade agreement depending on the political views of WTO member countries. That is why this section is going to discuss two different issues. The first is how granting originating status in preferential trade regimes could depend on the political perspectives of WTO member countries. The second is how preferential rules of origin could be used for political purposes. Both are origin-related issues and they need to be addressed because they do not make international trade transparent, predictable and smooth, contrary to the WTO's aim to liberalize international trade.[158]

The predictability and stability of international trade creates investment opportunities, jobs and a variety of choices for consumers.[159] Leaving preferential rules of origin free for the political misuse would negatively affect trade relations, hinder trade and make it unpredictable for traders, producers and consumers.

2.3.1 The Issue of Recognition.

There are a lot of territorial disputes worldwide. The question is: how would a WTO member country face such a situation when it comes to determining the origin of an imported product in a preferential trade regime?

[158] World Trade Organization, 'WTO Annual Report' (2013) 3 <http://www.wto.org/english/thewto_e/whatis_e/inbrief_e/inbr00_e.htm> accessed 16 August 2014. See also World Trade Organization, 'The WTO... ... In brief' <http://www.wto.org/english/thewto_e/whatis_e/inbrief_e/inbr00_e.htm> accessed 16 August 2014.
[159] World Trade Organization, 'Principles of the Trading System' (2014) <http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact2_e.htm> accessed 16 August 2014.

Article XXVI (5) (a) of the GATT states that: "Each government accepting this Agreement does so in respect of its metropolitan territory *and of the other territories for which it has international responsibility,* except such separate customs territories as it shall notify to the Executive Secretary to the CONTRACTINGPARTIES at the time of its own acceptance" (emphasis added). Such article illustrates that the answer to the question lies in the international responsibility of countries for the concerned territories.[160]

According to international law, Western Sahara is not recognized as being under the sovereignty of Morocco.[161] Article 94 of the EU-Morocco Association Agreement states that the Agreement "shall apply ... to the territory of the Kingdom of Morocco".[162] Despite that, the EU regards imports coming from Western Sahara as of Moroccan origin[163] because "the Moroccan government controls Western Saharan trade and economic activities".[164]

On June 1, 2000, the EU-Israel Association Agreement came into force.[165] The controversial question here is whether imports coming from the Israeli settlements in the West Bank and Gaza Strip shall be regarded as of Israeli origin. When it comes to the territorial application of the EU-Israel Association Agreement, Article 83 provides: "This Agreement shall apply, on the one hand, to the territories in which the Treaties establishing the European Community and the European Coal and Steel

[160] Moshe Hirsch, 'Rules of Origin as Trade or Foreign Policy Instruments? The European Union Policy on Products Manufactured in the Settlements in the West Bank and the Gaza Strip' (2002) 26 *Fordham International Law Journal* 572-593, 578.
[161] Advisory Opinion on Western Sahara [1975] I.C.J. Rep. 12 <http://www.icj-cij.org/docket/index.php?sum=323&p1=3&p2=4&case=61&p3=5> accessed 16 August 2014.
[162] Euro-Mediterranean Agreement establishing an association between the European Communities and their Member States, of the one part, and the Kingdom of Morocco, of the other part [2000] OJ L 70/20.
[163] Eyal Rubinson, 'More than Kin and Less than Kind: The Status of Occupied Territories under the European Union's Bilateral Trade Agreements' (2011) Konrad Adenauer Foundation Working Paper 97/2011.
[164] *Western Sahara Business Law Handbook: Strategic Information and Laws* (USA International Business Publications, Washington DC 2013) 12.
[165] European Union External Action Service, 'Agreements' <http://eeas.europa.eu/delegations/israel/eu_israel/political_relations/agreements/index_en.htm> accessed 16 August 2014.

Community are applied and under the conditions laid down in those Treaties and, on the other hand, to the territory of the State of Israel".[166] Therefore, it is not clear whether the Israeli settlements are considered as part of Israel according to the Article. However, according to United Nations Security Council Resolution 446, "the policy and practices of Israel in establishing settlements in the Palestinian and other Arab Territories occupied since 1967 have no legal validity and constitute a serious obstruction to achieving a comprehensive, just and lasting peace in the Middle East".[167] Accordingly, the EU Commission answered the question of the territorial application of the agreement by stating that: "All relevant United Nations Security Council resolutions [. . .] lead to the conclusion that neither Israeli settlements in the West Bank and Gaza Strip, nor east Jerusalem and the Golan Heights, can be considered as part of the State of Israel".[168]

The EU has adopted different approaches when it comes to conferring originating status in these two examples. While the EU regards the imports coming from Western Sahara as of Moroccan origin, it does not regard the imports coming from Israeli settlements as of Israeli origin. Also, sometimes national courts adopt their respective government's political approach. For example, in the UK, if the Foreign Office does not recognize an entity, the English courts regard it as if it does not exist.[169] Thus, originating status could be granted based on the foreign policies of WTO member countries in preferential trade regimes. However, granting originating status should be based on international law, resolutions of international organizations or

[166] Euro-Mediterranean Agreement establishing an association between the European Communities and their Member States, of the one part, and the State of Israel, of the other part (2000) L 147/17.
[167] UNSC Res 446 (12 July, 1979) UN Doc S/13450 <http://domino.un.org/UNISPAL.NSF/0/ba123cded3ea84a5852560e50077c2dc> accessed 16 August 2014.
[168] Sharon Pardo and Joel Peters, *Israel and the European Union* (Lexington Books, United Kingdom 2012) 223.
[169] Malcolm Shaw, *International Law* (6th edn CUP, New York 2008) 193.

international courts, such as the United Nations, General Assembly and International Court of Justice.

2.3.2 Using Preferential Rules of Origin to Pursue Political Objectives.

In practice, the application of preferential rules of origin sometimes depends on the foreign policies of WTO member countries.

Qualified Industrial Zones (QIZs) are free trade zones established by the US Congress in 1996 and amended the US-Israel FTA for the purpose of supporting "the peace process in the Middle East".[170] Accordingly, Egyptian and Jordanian products exported to the US are eligible for duty-free access, if the values of the Israeli components used to produce the Egyptian and Jordanian products are 11.7 % and 8 %, respectively, of the final product value.[171]Although these rules of origin are of a flexible and tolerant nature, they are designed to pursue the mentioned political aim.[172]

According to Israel's Ministry of Economy, Jordanian exports to the US were more than 1 billion dollars in 2004.[173] Total Israeli exports to Egypt as a result of the QIZs were $29 million in 2004; $93.2 million in 2005; and tripled in 2006. Moreover,

[170] The United States-Israel Free Trade Area Implementation Act of 1985, s 19, USC s 2112 as amended by Public Law 104-234 (1996). See also Office of Textile and Apparel (OTEXA), 'Qualifying Industrial Zone' (United States of America Department of Commerce International Trade Administration) <http://web.ita.doc.gov/tacgi/fta.nsf/7a9d3143265673ee85257a0700667a6f/196ed79f4f79ac0085257a070066961d> accessed 13 February 2014.
[171] State of Israel Ministry of Trade & Labor, 'Q.I.Z – Qualifying Industrial Zones' <http://www.moit.gov.il/NR/exeres/2124E799-4876-40EF-831C-6410830D8F02.htm> accessed 13 February 2014.
[172] Hirsch 'Rules of Origin as Instruments of Foreign and Domestic Policies' (n 120) 8.
[173] However, it did not clarify the amount of goods exported under the QIZs. "Jordanian exports" does not necessarily include the Jordanian exports under the QIZs.

the Ministry demonstrated that the amount of Egyptian exports to the U.S. was $1,283 million in 2004; more than $2 billion in 2005 and kept growing in 2006.[174] However, such numbers do not show Jordanian and Egyptian exports to the US under the QIZs as a percentage of the total exports of each. An Egyptian report in 2008 shows something different that reflects the negative consequences of using rules of origin as imperative political instruments. The report shows the number of Egyptian manufacturing firms that export to the US under the QIZ protocol. By June 5, 2008, 717 Egyptian manufacturing firms were listed as QIZ eligible. However, 77 % of such firms did not export under the QIZ protocol.[175] Another study shows that the percentage of Jordanian exports under the QIZ in 2008 was only 0.1505 of the "total Jordanian merchandise exports".[176]

Israel has been building settlements in the West Bank and Gaza Strip,[177] violating UN resolutions and fundamental human rights.[178] This made a lot of people worldwide,[179] especially in the Arab world, boycott Israeli products.[180] In this scenario, rules of origin were used for a political aim and became stuck in a political battle between (1) the Egyptian consumer and manufacturer and (2) the Egyptian, US, Jordanian and Israeli authorities that formed the QIZs without considering the attitude

[174] Israel's Ministry of Economy, 'Qualifying Industrial Zones' (Foreign Trade Administration 2014) <http://www.moital.gov.il/NR/exeres/5E659E0A-49C7-419A-8571-A87FB667AB4D.htm> accessed 13 February 2014.
[175] Saad El Morsi, '77 % of the QUIZ Firms Have Not Export to the U.S. Markets' [2008] (14) *Elmal* 5.
[176] Ahmed F. Ghoneim, 'Impact of Qualifying Industrial Zones on Egypt: A Critical Analysis' (2009) paper presented at the Virtual Institute UNCTAD meeting, Geneva, 23.
[177] BBC, 'Israel Approves 558 East Jerusalem Settlement Homes' (2014) <http://www.bbc.co.uk/news/world-middle-east-26056608> accessed 13 August 2014.
[178] Human Rights Watch, 'Gaza: Israeli Soldiers Shoot and Kill Fleeing Civilians' (2014) <http://www.hrw.org/news/2014/08/04/gaza-israeli-soldiers-shoot-and-kill-fleeing-civilians> accessed 17 August 2014.
[179] David Pollock, 'Threats to Israel: Terrorist Funding and Trade Boycotts' (2014) The Washington Institute for Near East Policy, Testimony submitted to the House Committee on Foreign Affairs Subcommittee on Terrorism, Nonproliferation, and Trade.
[180] Norwegian Shipowners' Association (NSA), 'Shipping Related Implications of the Arab League Boycott of Israel' [2012] NSA Contingency Planning Secretariat, 1. See also, Martin A. Weiss, 'Arab League Boycott of Israel' (2006) Congressional Research Service RS22424.

and preferences of the people (the consumers). Consequently, the result was not trade-encouraging.

Were preferential rules of origin designed originally for political purposes? No. International cooperation and peace processes are one thing and the use of preferential rules of origin something else. Preferential rules of origin are used to determine whether the good qualifies for preferential treatment, and not to pursue political objectives.

"So I propose the establishment of a U.S.-Middle East free trade area within a decade, to bring the Middle East into an expanding circle of opportunity, to provide hope for the people who live in that region."[181] George W. Bush.

On July 1, 1999, in Washington D.C, Egypt and the US signed the Trade and Investment Framework Agreement (TIFA). The purpose of the Agreement is to facilitate and expand the trade in goods between the two countries. Also, the Agreement is deemed to be an initial step to form an Egypt-US FTA.[182] The TIFA resulted in the improvement of the trading relationship between Egypt and the US.[183] This indicates that the formation of an Egypt-US FTA is desirable to strengthen the Egyptian-US trading ties.

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[181] The U.S. Department of State's Bureau of International Information Programs, 'Bush Calls for U.S.-Middle East Free Trade Area' <http://www.america.gov/st/washfile-english/2003/May/20030509173956ssor0.7209436.html> accessed 23 May 2013; See also, Jonathan Powell, 'Free Trade Agreements: The Quiet Economic Track of U.S. Middle East Policy' (2006) The Washington Institute Policy Analysis 1079 <http://www.washingtoninstitute.org/policy-analysis/view/free-trade-agreements-the-quiet-economic-track-of-u.s.-middle-east-policy> accessed 10 August 2014.

[182] Arab Republic of Egypt Ministry of Trade and Industry, 'Egypt- USA Trade and Investment Framework Agreement (TIFA)' (2008) <http://www.mfti.gov.eg/english/Agreements/TIfa.htm> accessed 16 August 2014.

[183] Bernard Hoekman and Denise Konan, 'Economic Implications of an Egypt-US FTA' in Ahmed Galal and Robert Z. Lawrence (eds), *Anchoring Reform With a US-Egypt Free Trade Agreement* (Washington DC: Institute for International Economics 2005) 47.

On May 9, 2003, the then US president, George W. Bush, urged the formation of the Middle East Free Trade Area Initiative (US-MEFTA).[184] At the time Secretary Rice paid Egypt a visit, she said: "we want to have an FTA with Egypt because we believe it will make a difference to economic reform and ultimately to the economy here in Egypt."[185] In 2011, Lionel Johnson, vice president of Middle East and North Africa Affairs said: "closer trade relations between the United States and Egypt can bring growth and jobs for both countries".

Qualifying industrial zones are cumulation zones (explained in the next chapter). Without qualifying industrial zones, Egyptian and Jordanian firms would not be able to export duty-free to the US because whether the goods could be exported duty-free would depend on whether US law or bilateral treaties between the USA and Egypt/Jordan provided for duty-free trade. However, the elimination of qualifying industrial zones could combat the use of preferential rules of origin for political purposes. Besides, once a US-Egypt FTA is formed, Egyptian firms would still be able to export their goods to the US duty-free provided they comply with the US-Egypt FTA rules of origin, but would the US-Egypt FTA rules of origin be flexible, transparent and not protectionist?

Chapter II clarified the protectionist practice of the US when it comes to the application of preferential rules of origin. That is why the harmonization of preferential rules of origin in the WTO system is needed. Doing so, along with the elimination of qualifying industrial zones, would leave no room for WTO member countries to use rules of origin as political instruments in preferential trade regimes. Moreover, the WTO should take into account that it is desirable for WTO member

[184] Daniel T. Griswold, 'Free Trade Agreements: Steppingstones to a More Open World' (2003) Trade Briefing Paper 18 CATO Institute, 2.
[185] United States House of Representative, 'Review of the U.S. Assistance Programs to Egypt' (2006) <http://commdocs.house.gov/committees/intlrel/hfa27645.000/hfa27645_0f.htm> accessed on 27 August 2014.

countries to comply with international law, resolutions of international organizations and international courts when it comes to the recognition of disputed territories.

2.4 The Worldwide Proliferation of Preferential Rules of Origin.

Both Article XXIV and the Enabling Clause engendered a massive number of preferential trade agreements. As of December 2008, about 421 preferential trade agreements were notified to the WTO.[186] 511 preferential trade agreements were notified to the WTO as of January 15, 2012. In 2014, the number of notified agreements grew to 585. The establishment of new preferential trade agreements has led to the introduction of more new rules of origin to international trade. The worldwide proliferation of rules of origin puts traders and producers in a nightmare of complying with and understanding different rules of origin imposed "arbitrarily" in different preferential trade agreements all over the world, resulting in high administrative costs. Such complexity does not make international trade transparent, predictable and smooth.[187]

Preferential rules of origin are set out with great elaboration in preferential trade agreements. They could be itemized in 200 pages or more (such as the NAFTA). Moreover, the application of preferential rules of origin differs from one agreement to another, making things complicated for a trader whose country is a member in a variety of agreements that impose different rules of origin.

Bhagwati stated that industries favor the formation of FTAs so as to gain by the provided preferences an advantage that their outsider rivals would not earn.

[186] World Trade Organization, Regional Trade Agreements (n 29).
[187] Peter Sutherland and others, *The Future of the WTO: Addressing Institutional Challenges in the New Millennium*, Report by the Consultative Board to the Director General Supachai Panichpakdi (Geneva: World Trade Organization, 2004) 19-21.

Moreover, he illustrated that the variation in rules of origin and "regulations" across FTAs increases production costs, is deemed to be a dilemma for "customs administration", and leads to what is named the "spaghetti-bowl" phenomenon.[188] To be granted originating status, a final good could be produced differently twice: (1) by using inputs imported from one country to comply with a preferential trade agreement's rules of origin; (2) and by using inputs imported from *another* country to comply with another preferential trade agreement's rules of origin. Such complex pattern of trading makes enterprises face difficulties when complying with a diversity of costs provoked by different agreements, especially when it comes to the imposition of stringent rules of origin. This is what Bhagwati envisaged as a bowl of spaghetti.[189]

The APEC consists of 21 participants.[190] Many agreements are formed between its members. The following figure shows the bulk of the Spaghetti Bowl Phenomenon within the APEC region as of 2009. In fact, such a phenomenon could also be visualized as a plague because a deeper look at the figure, or the fact that preferential trade agreements are growing in general, shows that preferential trade agreements spread like a plague, where the victims are those traders who suffer because of such a complicated system.

The circles in the next figure represent the APEC members, while the lines represent an existing preferential trade agreement between the circles/members they connect with each other.

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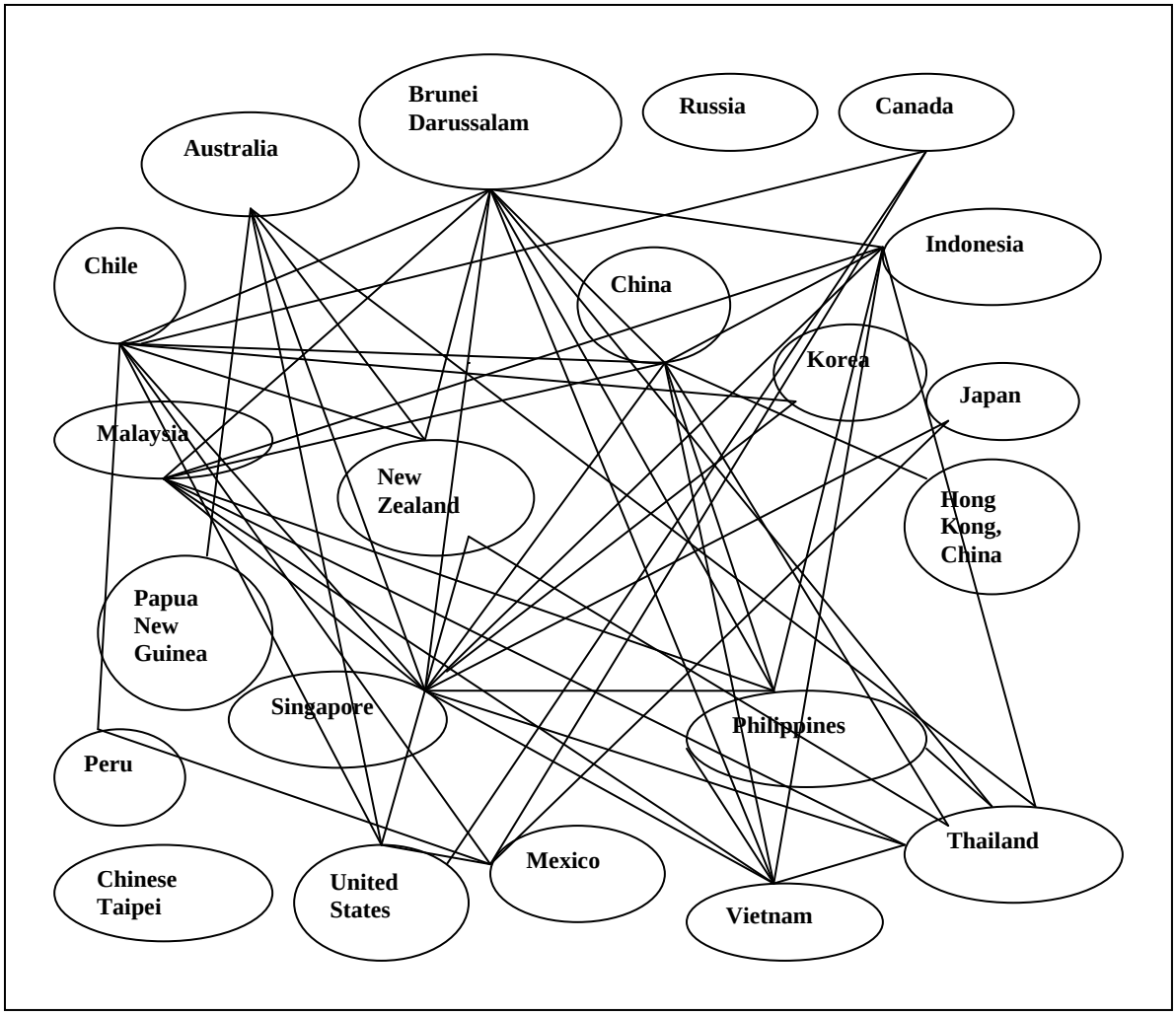
[188] Jagdish Bhagwati as quoted by Cooper (n 121) 11-12.
[189] Ibid 12.
[190] Namely, Australia, Brunei Darussalam, Canada, Chile, People's Republic of China, Hong Kong - China, Indonesia, Japan, Republic of Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, the Philippines, Russia, Singapore, Chinese Taipei, Thailand, the United States and Vietnam. Please see APEC, ' Member Economies' <http://www.apec.org/About-Us/About-APEC/Member-Economies.aspx> accessed on 12 August 2014.



Source: Author's analysis based on
http://www.apec.org/webapps/fta_rta_information.html#others_fta

At the moment, nothing can be done to either lessen the number of the preferential trade agreements notified to the WTO or prohibit the formation or new ones. However, the most practical solution to combat the spaghetti bowl phenomenon is to harmonize preferential rules of origin. Regardless of the number of preferential trade agreements that will be formed in the future, one set of preferential rules of origin could be applied to all of them. This would consequently reduce the complexity that traders and producers face and make international trade transparent, clear and predictable.

2.5 Summary.

Preferential rules of origin are used to determine which imported goods qualify for preferential tariff treatment. The contracting parties to preferential trade agreements are free to impose any rules of origin they see fit. Such freedom can lead to the misuse of preferential rules of origin.

Misusing preferential rules of origin can hinder international trade in various ways. The contracting parties in preferential trade agreements could use rules of origin to pursue protectionist, trade-diverting or political objectives, as clarified in this chapter. In addition, rules of origin should be transparent and clear. The complexity of rules of origin and their proliferation worldwide confuses traders and producers and does not make international trade transparent, clear or smooth.

74 new preferential trade agreements were notified to the WTO during the past two years. Consequently, one can imagine how many rules of origin traders and producers are expected to become acquainted with every year. Of course, this makes international trade complicated, and not transparent or predictable, even though the main objective of the WTO is to liberalize trade. The most practical solution to overcome the problem of misusing preferential rules of origin would be to harmonize them. This issue is discussed in the next chapter.

CHAPTER III

THE HARMONIZATION OF PREFERENTIAL RULES OF ORIGIN

Rules of origin vary from country to country and from one preferential trade agreement to another. They are so complex and involve a lot of technicalities. To determine the origin of a good, one or more origin determination methods could be applied. Moreover, the existence of cumulation rules makes things worse for a lot of traders and producers,[191] although they are considered by some to facilitate trade. Even if they facilitate trade in some cases, one question arises: how many rules do the public and traders have to know in order to practise trade and know their rights and obligations? For this reason, the proper harmonization of rules of origin worldwide would be desirable in order to facilitate international trade and spread welfare all over the world.

Efforts to harmonize rules of origin were made in 1953 by the International Chamber of Commerce. The latter submitted a proposal to the GATT members suggesting that they agree upon a regular "definition for determining the nationality of manufactured goods."[192] At that time, some countries declared that the determination of origin should be based on the "national economic policies" of each country. Other countries preferred a global origin designation criterion along with regular origin-specifying rules. As a result, the suggestions of the International Chamber of Commerce were not embraced by the GATT.[193]

[191] Cumulation, accumulation or accumulative rules treat the inputs used to produce the final product as if they are originating in that country, as long as they are imported from a certain country or countries (as will be explained later).
[192] LaNasa III (n 35).
[193] Ibid.

On September 25, 1974, the Kyoto Convention came into force.[194] Annex D (which is Annex K currently) of the Convention was deemed to be another trail to harmonize rules of origin.[195] The Kyoto Convention is aimed at harmonizing both preferential and non-preferential rules of origin for both of which it provides a set of standards to be followed when determining the origin of imported goods, whether they are wholly obtained in one country or more than one country is engaged in their production. According to the Kyoto Convention, when it comes to the latter case, the country of origin is defined as the country where the last substantial transformation was performed.[196] The Kyoto Convention lays down a set of principles that specify what operation constitutes a substantial transformation.[197] Unfortunately, many GATT contracting parties did not ratify Annex D of the Kyoto Convention and the Annex has not been regarded as a model to be followed by others of them.[198]

In the course of Uruguay Round, an agreement on rules of origin was discussed. In 1995, the Agreement was adopted, which partially harmonizes non-preferential rules of origin.[199]

This chapter discusses the WTO's efforts to harmonize non-preferential rules of origin. The chapter also clarifies how to overcome some problems concerning the application of rules of origin worldwide. Then, the chapter demonstrates how to harmonize preferential rules of origin and offers a very simple set of harmonized

[194] International Convention on the Simplification and Harmonization of Customs Procedures (Kyoto, 18 May 1973) entered into force: 25 September 1974<http://www.wcoomd.org/en/topics/facilitation/instrument-and-tools/conventions/pf_revised_kyoto_conv/~/media/A7D0E487847940AD94DD10E3FDD39D60.ashx> accessed 23 August 2014.
[195] Annex D.1 (Rules of origin), Annex D.2 (Documentary evidence of Origin) and Annex D.3 (Control of documentary evidence of origin) of the unrevised version of Kyoto Convention. In the Current revised version of Kyoto Convention, Annex D became K, Annex D.1 became Chapter 1, Annex D.2 became Chapter 2 and Annex D.3 became Chapter 3.
[196] International Convention on the Simplification and Harmonization of Customs Procedures (n 194) Annex K, Chapter 1: Rules of Origin, para 3.
[197] Ibid Annex K, Chapter 1: Rules of Origin, paras 4-11.
[198] Inama (n 72) 3-4.
[199] Agreement on Rules of Origin (n 47).

preferential rules of origin to be hopefully implemented in the WTO system and followed by all WTO member countries. Finally, the chapter sheds light on some negotiations that are currently taking place and that must be taken into account.

3.1 The Harmonization of Non-preferential Rules of Origin

The harmonization of non-preferential rules of origin has been undertaken by the WTO Committee on Rules of Origin in Geneva in association with the WCO Technical Committee on Rules of Origin in Brussels.[200] The process was supposed to be completed after three years from the commencement of the Harmonization Work Programme, which started on 20 July 1995 (i.e. by 20 July 1998). However, it has not been completed yet due to the existence of a number of outstanding issues.[201]

Prior to the completion of the harmonization process (during the transition period), the WTO member countries are not allowed to make alterations to their rules of origin that suit their interests and protect their national susceptible goods. Besides, any new rules of origin must be imposed transparently, without discrimination, without hindering international trade, and in an orderly and non-retroactive way.[202]

Once the harmonization process is completed, the harmonized non-preferential rules of origin should be integrated in the Agreement as an annex, and consequently, the WTO member countries would have to bring them into effect for the purpose of applying MFN treatment from the enforcement date specified by the WTO Ministerial Conference.[203] Furthermore, the origin of the product will be determined according to

[200] World Trade Organization, 'Technical Information on Rules of Origin' (2014) <http://www.wto.org/english/tratop_e/roi_e/roi_info_e.htm> accessed 23 August 2014.
[201] World Trade Organization, 'The WTO and World Customs Organization' (2014) <http://www.wto.org/english/thewto_e/coher_e/wto_wco_e.htm> accessed 23 August 2014.
[202] Agreement on Rules of Origin (n 47) art 2.
[203] Ibid art 9(4).

the last substantial transformation norm,[204] where the change in tariff classification test will be applied, if more than one country is involved in the production of the good (i.e. if the product is not wholly produced in one country). Moreover, in case the change in tariff classification will not be enough to confer origin on the product, the value content and/or the specific manufacturing operation test will be implemented.[205]

3.1.1 The Outstanding Issues Obstructing the Completion of the Harmonization Process of Non-preferential Rules of Origin.

In June 1999, 486 outstanding issues concerning the harmonization of non-preferential rules of origin were submitted to the Committee on Rules of Origin.[206] In November, 2001, the Doha Development Agenda was launched at the Fourth WTO Ministerial Conference with the aim of liberalizing international trade, by lowering "trade barriers" and reviewing "trade rules".[207] One of the Agenda's objectives was to complete the harmonization of non-preferential rules of origin by the end of 2001.[208] However, this deadline was subsequently extended until the end of 2002.[209]

[204] Ibid art 3(b).
[205] Ibid art 9(2).
[206] WTO, G/RO/41 (3 September 1999). This is a restricted document, but on file with the author.
[207] Implementation-Related Issues and Concerns (on the Ministerial Conference Fourth Session of November 2001 in Doha, November 2001) WT/MIN(01)/17 <http://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_implementation_e.htm> accessed 23 August 2014.
[208] International Monetary Fund, 'The WTO Doha Trade Round: Unlocking the Negotiations and Beyond' (2011) paper presented by the Strategy, Policy, and Review Department and Approved by Tamim Bayoumi, 12 <https://www.imf.org/external/np/pp/eng/2011/111611.pdf> accessed 20 December 2014.
[209] World Trade Organization, 'Agreement on Rules of Origin' (2014) para 28 <http://www.wto.org/english/res_e/booksp_e/analytic_index_e/roi_01_e.htm> accessed 23 August 2014.

By June 2002, the number of outstanding issues had been reduced to 138.[210] In July 2002, the Committee on Rules of Origin referred 94 issues to the General Council. Out of these 94 issues, about 30 products are currently implicated in 83 issues on product-specific rules of origin.[211] The General Council decided to concentrate on the following 12 of these 94 issues: "Implications of the implementation of the Harmonized Rules of Origin on other WTO Agreements;[212] Dyeing and printing of textile products; Coating of steel products; Assembly of machinery; Assembly of vehicles; Refining of sugars; Roasting of coffee; Slaughtering of live animals; Refining of oils; Fish taken from the sea of the exclusive economic zone;[213] Footwear; and Dairy products".[214] Since 2002, the deadline for completing the harmonization of non-preferential rules of origin has been extended from one year to the next.

There are ongoing negotiations to complete the harmonization of non-preferential rules of origin. In 2007, the Committee on Rules of Origin produced a draft Consolidated Text of Non-preferential Rules of Origin, which was then revised and "circulated" on November 11, 2010.[215] The draft consolidated text includes a

[210] Report by the Chairman of Committee on Rules of Origin to the General Office (15 July 2002) G/RO/52 <http://docsonline.wto.org/imrd/directdoc.asp?DDFDocuments/t/G/RO/52.doc> accessed 23 August 2014.
[211] Estevadeordal, Harris and Suominen, 'Multilateralising Preferential Rules of Origin around the World'(n 49) 13 See also Harmonization Work Programme Under the Agreement on Rules of Origin – The Way Forward (April 2010) WT/GC/W/622, para 7, 2 <http://docsonline.wto.org/imrd/directdoc.asp?DDFDocuments/t/wt/gc/w622.doc> accessed 27 August 2014.
[212] In other words, the impact the harmonized rules of origin would have on other WTO agreements.
[213] This is the only wholly obtained issue among the 94 issues. The wholly obtained issue concerned the question of what origin to confer on the fish caught in the Exclusive Economic Zone and more specifically, whether it should be based on the flag of the member attached to the fishing vessel or on the coastal country.
[214] Vermulst (n 156) 9 See also Walter Stocker, 'The WCO Seminar on the Harmonization of Non-preferential Rules of Origin' (2008) World Customs Organization <http://portal.dga.gov.do/dgagov.net/uploads/file/seminario_regional_oma/01rules-of-origin-english.pdf> accessed 22 May 2014 (discussing details concerning similar issues and their resolution).
[215] Draft Consolidated Text of Non-preferential Rules of Origin (November 2010) G/RO/W/111/Rev.6 <https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S009-

draft Annex III to the Agreement on Rules of Origin and a draft Ministerial decision to adopt the Annex. The draft Annex III provides: "general rules; an appendix defining goods that are to be considered as being wholly obtained in one country; and an appendix of product-specific rules of origin for each chapter of the Harmonized System of customs classification".[216]In April 2014, the WTO Secretariat presented the last draft Consolidated Text of Non-preferential Rules of Origin to the WTO member countries delegates.[217] Thereafter, the Chairman[218] of the Committee on Rules of Origin "reported on his consultations with delegations on a possible way forward for the Committee's harmonization work programme on non-preferential rules origin".[219]

The inability of the WTO contracting parties to settle the outstanding issues until now is reflected in their importance, since such issues directly affect the interests of the parties. This is why cooperation is needed between the WTO member countries to resolve these outstanding issues.

DP.aspx?language=E&CatalogueIdList=87171,103528,72848,72834,73699,66435,91395,13417,87542,63928&CurrentCatalogueIdIndex=1&FullTextSearch=> accessed 23 August 2014.

[216] World Trade Organization, 'Agreement on Rules of Origin' (n 209) para 31.

[217] Minutes of the Meeting of 10 April 2014 (April 2014) G/RO/M/62, 2014, para 3.2 <https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S009-DP.aspx?language=E&CatalogueIdList=125359,123668,123622,122499,122165&CurrentCatalogueIdIndex=0&FullTextSearch=> accessed 23 August 2014.

[218] Mr. Marhijn Visser (The Netherlands).

[219] World Trade Organization, 'Steps agreed on implementing Bali decision on rules of origin for LDCs' (2014) <http://www.wto.org/english/news_e/news14_e/roi_10apr14_e.htm> accessed 23 August 2014.

3.1.2 Problems Concerning the Application of Non-preferential Rules of Origin Worldwide and Suggestions to Overcome Remaining Obstacles to Their Harmonization.

As explained in Chapter I, there are three methods of determining origin. Each method has its advantages and disadvantages. This section explains the advantages and disadvantages of each method of determining origin. Moreover, the section offers solutions on how to avoid the disadvantages and discusses the issue of the countries who are not yet members of the WTO. After all, even when non-preferential rules of origin are harmonized, non-WTO members would not be obliged to apply them to imported goods.

a. The Change in Tariff Classification Method.

The implementation of the change in tariff classification method[220] is flexible and uncomplicated. However, its application is relevant to the HS, seeing that a profound acquaintance concerning the latter would be required once the non-preferential rules of origin are harmonized. Moreover, the HS was not formed, on the whole, for origin specification objectives. That is why the itemization of two kinds of certain production processes is needed: processes that do not grant originating status, even though they engender a change in tariff classification, and processes that grant originating status, in spite of the fact that they do not result in a change in tariff classification.[221]

[220] The change in tariff classification was discussed in Chapter 1.
[221] Vermulst (n 156) 5.

b. The Value Content Requirement.

There are three types of the value content requirement:[222]

- The import value content requirement: origin is to be conferred on the final product, if the value of the imported inputs used in producing it is not higher than the maximum value specified by the rule.
- The local value content requirement: origin is to be conferred on the final product, if the value of the domestic inputs used in producing it is not lower than the minimum value required by the rule.
- The value of originating parts requirement: origin is to be conferred on the final product if the value of the originating parts used in its production is not lower than the minimum value required by the rule.[223]

Although the value content test is transparent and uncomplicated when identified, there are defects in its application. The import and local value content requirements are the most commonly used in non-preferential and preferential trade regimes. Some countries prefer the application of the former and other countries prefer the application of the latter. To calculate the percentage of the value content, the numerator must be divided by the denominator and then multiplied by 100. When the import value content method is applied, the numerator is the value of non-originating inputs. On the other hand, when the local value content is applied, the numerator becomes the value of originating inputs. Generally speaking, the value of the final product consists of the value of the originating and non-originating inputs. The denominator is the delivery term the final product is to be valued at. The applicable

[222] The value content requirement was explained in Chapter 1.
[223] Vermulst (n 156) 6.

delivery term varies from one country to another and from one preferential trade agreement to another as well. Furthermore, relying on the value content requirement could chastise efficient production processes in countries with cheap labour and inputs, which could certainly affect the value of the elements counted as originating. Also, due to the fluctuation of the prices of inputs and exchange rates, calculating the percentage of the value content is not constant. Explaining these issues and offering solutions on how to combat them are discussed below.

i. The Import Value Content Requirement vs. the Local Value Content Requirement.

The WTO member countries should agree on whether the applicable value content requirement is going to be the import value content requirement or the local value content requirement when it comes to the harmonization of non-preferential rules of origin.[224] As for the value of originating parts requirement, it concentrates only on the value of the parts and does not take into consideration the costs of assembly and the manufacturing overheads in the local production process. That is why the value of originating parts requirement is unfair and traders and producers have complained about its stringency.[225] Generally, the import value content requirement is applied by many jurisdictions.[226] For example, it is applied in the EU

[224] Edwin A. Vermulst, Jacques Bourgeois and Paul Waer (eds), *Rules of Origin in International Trade: A Comparative Study*, (Ann Arbor: University of Michigan Press, 1994) 478.
[225] Inama (n 72) 441-442. See also ibid 437.
[226] Rajan Ratna, 'Rules of Origin: Diverse Treatment and Future Development in the Asia and Pacific Region', in Economic and Social Commission for Asia and the Pacific (ESCAP) (ed.), *Towards Coherent Policy Frameworks – Understanding Trade and Investment Linkages*, (Bangkok: ESCAP, 2008) 76, 67-91. See also Brenton, 'Notes on Rules of Origin with Implications for Regional Integration on Southeast Asia' (n 55) 21.

preferential trade regimes. Moreover, applying it is uncomplicated,[227] would lessen the administrative obstacles [228] and would not need circumstantial instantaneous inspections on the "data provided."[229]

ii. The Denominator and the Numerator: An Emphasis on the EU's Practice.

As previously explained, to calculate the percentage of the local content, the value of originating inputs[230] (the numerator) should be divided by the denominator and then multiplied by 100. To calculate the percentage of the import content, the value of the non-originating inputs (the numerator) —at a specific delivery term— should be divided by the denominator and then multiplied by 100. The denominator is the value of the final good at a specific delivery term. Since the denominator and the numerator used to calculate the value content percentage may differ from one country to another and from one preferential trade agreement to another, the EU's standards of calculating the value content percentage will be used as the model to be followed by all WTO member countries because the EU complies with the rational recommendations of the Kyoto Convention when it comes to calculating the value content percentage.

[227] Applying it is uncomplicated because the import value content percentage can be simply calculated by adding only the costs of the imported inputs valued at the specified delivery term together, dividing such costs by the denominator and multiplying the remainder by 100, contrary to calculating the percentage of the local value content where the costs of a variety of local content factors must be added together before being divided by the denominator and then multiplied by 100.
[228] Administrative obstacles take place particularly when it comes to using the value of originating parts requirement. In spite of this, such obstacles will be lessened if the import value content requirement is going to be a supplementary origin determination criterion after the harmonization of non-preferential rules of origin.
[229] Vermulst, Bourgeois and Waer (n 224) 448-49, 479.
[230] The sum of the factors that are counted as parts of the local content.

The EU uses the Cost Insurance & Freight (CIF) price to value imported inputs.[231] The CIF price is the price paid to the exporter of inputs at the time of importation, which includes the freight and insurance costs incurred to transfer the goods[232] to the port of importation.[233] Accordingly, any payable charges "incurred from" transferring the goods from the manufacturing firm in the exporting country until they reach the border of the importing country are to be regarded as non-originating and the payable charges incurred after crossing the border of the importing country are to be regarded as originating.[234] Moreover, the EU uses the ex-works price[235] as the denominator. The ex-works price is the cost of the final product from the manufacturing firm. This means that the ex-works price includes all costs incurred in producing the final product up to the time placing it in the manufacturing firm - i.e. it includes the costs of all inputs[236] (the cost of the originating inputs + the value of the non-originating inputs at the specified delivery term),[237] direct labour costs,[238] factory costs, Selling, General & Administrative Expenses (SG&A),[239]

[231] Commission Regulation (EEC) No 2454/93 laying down provisions for the implementation of Council Regulation (EEC) No 2913/92 establishing the Community Customs Code [1993] OJ L 253, as amended [2013] OJ L 341. Pursuant to Article 40, 39 ("origin is conferred if the value of the non-originating materials used does not exceed a given percentage of the ex-works price of the products obtained, such percentage shall be calculated as follows: 'value' means the customs value at the time of import of the non-originating materials used or, if this is not known and cannot be ascertained, the first ascertainable price paid for such materials in the country of processing.").

[232] These are the intermediate goods (inputs) that will be used to produce the final product.

[233] For different definitions of International Commercial Terms (Incoterms), see World Customs Organization, 'Definitions' <http://www.wcoomd.org/en/topics/origin/instrument-and-tools/comparative-study-on-preferential-rules-of-origin/specific-topics/study-topics/def.aspx?p=1> accessed 23 August 2014.

[234] Hatem Mabrouk, 'Rules of Origin as International Trade Hindrances' (2010) 5 *Entrepreneurial Business Law Journal* 98, 158-159. See also Vermulst, Bourgeois and Waer (n 224) 438.

[235] Commission Regulation (EEC) No. 2454/93 (n 231) art 40, 39 ("'ex-works price' means the ex-works price of the product obtained minus any internal taxes which are, or may be, repaid when such product is exported.").

[236] Both kinds of inputs (the originating and the non-originating) are known as direct materials.

[237] For example, if the imported inputs are valued at the FOB price, all costs incurred in producing the inputs up to delivering them on board the shipping vessel, at the agreed specified export port (pursuant to the terms of the sale contract), will be regarded as non-originating and all charges incurred for transportation and insurance will be regarded as originating. Hence, only such originating charges will be included in the denominator and will be thus regarded as part of the local content.

[238] The manufacturing costs (or product costs) consist of direct and indirect manufacturing costs. While the direct manufacturing costs comprise the direct materials and direct labour costs, the indirect costs

packing expenditures and profit (if available).[240] Therefore, the denominator is the addition of the value of the originating inputs to the value of the non-originating ones.

All of the mentioned elements, with the exception of the value of the non-originating inputs, are factors counted as part of the local content. Their sum gives the numerator, if the ex-works price is used as the denominator and the method of calculation is the local content. However, if the method of calculation is the import content, only the value of the non-originating inputs will be the numerator. That is why determining what factor is to be counted as part of the local content, and consequently calculating the numerator, depends on the denominator used.[241]

Since the EU uses the ex-works price as the denominator and values the imported inputs at the CIF price, it complies with Recommended Practice 5 of Chapter 1 of Annex K of the Kyoto Convention.

Pursuant to the Recommended Practice 5 of Chapter 1 of Annex K of the Kyoto Convention, the final product should be valued at the ex-works or the FOB (Free on Board) price[242] (the denominator). Moreover, the imported inputs should be

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comprise the factory costs (or manufacturing overheads). The factory costs include the indirect labour, indirect materials and factory-related costs.

[239] The SG&A expenses, *Ipso facto*, include the wages for administrators, royalties (only if they are rational under the EU's standards), insurance, traveling expenditures for the administrators and those who are assigned to sell the goods, expenses for heat and lighting, costs of leasing facilities, and payroll outlays. However, when it comes to using the ex-works price as the denominator, any SG&A expenses incurred subsequent to the departure of the product from the manufacturing firm must be taken away. Thus, direct selling expenses will be disregarded. See next footnote.

[240] Vermulst, Bourgeois and Waer (n 224) 442, 433-485. See also, in such book, a comparative analysis on the use of different denominators and the numerator calculations by different jurisdictions: the US, the EU, Japan, Australia and Canada. It is to be noted that under the EU's standards, if the profit is not rational, it will not be included in the denominator or the ex-works price.

[241] However, that is not always the case because although the US in its preferential trade regimes uses the FOB price as the denominator which comprises the SG&A expenses and profit, it does not count the latter elements as local content factors (only royalties are included in the numerator because sometimes they are comprised in the factory costs and not the SG&A expenses). See Hatem Mabrouk (n 234)160-161.

[242] The FOB price in Recommended Practice 5 of Chapter 1 of Annex K of the Kyoto Convention is referred to as "the price at exportation". See International Convention on the Simplification and Harmonization of Customs Procedures (n 194) Annex K, Chapter 1: Rules of Origin, para 5.

valued on a CIF basis.[243] The FOB price is the price paid to the exporter at the agreed port of exportation when the goods are loaded onto the carrier.

Although valuing the final goods at the FOB price complies with Recommended Practice 5 of Chapter 1 of Annex K of the Kyoto Convention and results in the containment of the numerator to more local content factors,[244] the ex-works price has been agreed to be more suitable than the FOB price when used as the denominator.[245] Using the latter as the denominator is deemed to be unfair to the factories that are situated far away from the seaport because the more distance that exists between the factory and the seaport, the more transportation costs from the factory to the seaport will have to be paid. Hereby, using the FOB as the denominator will provide the factories situated near the seaport with a specialty (less transportation costs) that the factories situated far away from the seaport will not have. Hereby, using the ex-works price instead of the FOB price as the denominator is deemed to be fairer, in spite of the fact that using any of them as the denominator complies with the rational recommendations of the Kyoto Convention.

The denominator and the numerator used to calculate the value content percentage may differ from one country to another and from one preferential trade agreement to another.[246] That is why using the EU's standards of calculating the value content percentage as the model to be followed by all WTO member countries seems to be the most reasonable solution because, as previously mentioned, the EU complies with the recommendations of Kyoto Convention when it comes to calculating the

[243] The CIF price in Recommended Practice 5 of Chapter 1 of Annex K of the Kyoto Convention is referred to as "the dutiable value at importation". Ibid.
[244] When compared with using the ex-works price as the denominator.
[245] Vermulst, Bourgeois and Waer (n 224) 442.
[246] For instance, the denominator used in the US preferential trade schemes is the transaction value. The transaction value is "the value of the good adjusted to a FOB. basis". For an example, see North American Free Trade Agreement (n 51) art. 402.

value content percentage, i.e. to use the ex-works price as the denominator, to value the imported inputs at the CIF price[247] and to use the EU's same local content factors for calculating the numerator.[248]

iii. Chastising Efficient Production Processes.

The value content requirement chastises "low cost or efficient production operations"[249] in countries with cheap labour and inputs because such cheapness makes it difficult for the producers to include costly local content factors in the numerator to comply easily with the value content requirement, contrary to the producers in countries with expensive labour and inputs. Consequently, least developed countries, by reason of the value content requirement, are discriminated against and do not benefit from the advantage of low-cost production operations that they only have over developed countries.[250] Despite that, after the harmonization of non-preferential rules of origin, the efficient producers in the lesser-developed countries would not deal with the aforementioned problem in most cases because the value content requirement would be used as a supplementary, and not primary, origin designation criterion.

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[247] While the EC, Japan, Australia and Canada use the CIF price to value the imported inputs, the US uses the FOB price. See Hatem Mabrouk (n 234) 161.

[248] It could have been sufficient to urge using the EU's denominator and the valuation criterion of imported inputs (the CIF price) since this would consequently specify what factor is to be counted as part of the local content. However, that is not always the case because although the US, for example, in its preferential trade regimes uses the FOB price as the denominator which comprises the SG&A expenses and profit, it does not count the latter elements as local content factors (only royalties are counted because sometimes they are comprised in the factory costs and not the SG&A expenses). This is why all WTO member countries should use the EU's local content factors to calculate the numerator since this, as illustrated, is the most reasonable solution. See ibid.

[249] Vermulst, Bourgeois and Waer (n 224) 447.

[250] Paul Brenton, 'Preferential Rules of Origin', in Jean-Pierre Chauffour and others (eds), *Preferential Trade Agreements Policies for Development: A Handbook* (World Bank, Washington DC 2011) 161-168, 163.

iv. The Instability of the Prices of Inputs Worldwide and the Fluctuation of Exchange Rates.

Due to the instability of the prices of inputs and exchange rates, calculating the percentage of the value content is not constant and generates uncertainty for producers.[251] The value content method takes no account of the exchange rates fluctuation and the instability of the prices of inputs. As the value of the currency and the price of inputs change, the originating status of a finished good can change on daily basis.

Exchange rates tend to be going up and down. They change frequently. According to Brenton, "[a]n operation which confers origin today may not do so tomorrow if exchange rates change."[252] However, Brenton used the word "may". This clarifies that the opposite of what he said may also happen, if exchange rates change positively, which would offset some of the uncertainty for traders. In other words, the currency risk is a two-edged sword: what is positive for one party is negative for the other. Given that exchange rates always fluctuate, the problem is insuperable, unless a global economic and monetary union is going to be formed. However, there are ways to minimize the fluctuation of prices of inputs and exchange rates problem. The first is if the final good producer obtains a binding advance ruling from the country's customs administration. The second is by using the weekly, monthly or annual average exchange rates. [253]

Based on the arguments in the previous subparts, the WTO member countries have to bear in mind that the EU's denominator (ex-works price), local content factors

[251] LaNasa III (n 35) See also Teruo Ujie, 'Trade Facilitation' (2006) Manila, Asian Development Bank, Economic and Research Department, Working Paper Series 78, 11 <http://www.adb.org/publications/trade-facilitation> accessed 29 August 2014.
[252] Paul Brenton, 'Preferential Rules of Origin' (n 250) 163.
[253] LaNasa III (n 35) Ch. IV, B.

and valuation method of imported inputs (at the CIF price) can lay a good groundwork for the harmonization of non-preferential rules of origin that depend on the value content requirement. In addition, the import value content requirement of a tolerant percentage should be applied instead of the local value content one.

c. The Specific Manufacturing Operation Method.

Like the value content test, the specific manufacturing operation method is transparent and not obscure when identified. It is also concrete. However, it has its share of defects.

The specific manufacturing operation method always engenders product-specific rules of origin[254] and is misused pursuant to national "interests." [255] Another problem with the specific manufacturing operation test is when the rule of origin requires the measurement of complicated production operations. The rule then becomes stringent and complying with it becomes difficult.[256] That is why the rule should require the simplest possible operations for producing the good to be taken into account when it comes to using the specific manufacturing operation test as a supplementary origin designation method. By solving the product-specific outstanding issues and by completion of the harmonization process of non-preferential rules of origin, the specific manufacturing operation method would not engender product-specific origin rules any longer and would not be misused pursuant to national interests.

[254] Paul Brenton, 'Preferential Rules of Origin' (n 250) 163.
[255] Vermulst, Bourgeois and Waer (n 224) 450.
[256] Paul Brenton, 'Preferential Rules of Origin' (n 250) 164, explaining the advantages, disadvantages, and key issues of the three methods of determining origin.

An example of a tolerant specific manufacturing operation rule is that indicated in Dominican Republic–Central America Free Trade Agreement (DR-CAFTA), where a reasonable single transformation process is required to be complied with for certain textile products which are: "brassieres (HS subheading 6212.10), certain woven boxer shorts and pajamas (found in HS headings 6207 through 6208), and certain woven women's/girls' dresses (found in HS subheadings 6204.42 through 6204.44)."[257]

d. Non-WTO Member Countries.

It is worth explaining that in the case of non-preferential rules of origin, determining the origin of the goods becomes a problem in practice if goods are imported in a non-WTO member. A non-WTO member could impose non-preferential rules of origin that do not comply with the disciplines provided by the Agreement on Rules of Origin. This means that even when non-preferential rules of origin are harmonized, non-WTO members would not be obliged to apply them to imported products.

Currently there are 24 WTO observer countries. About 14 countries are neither WTO observers nor members.[258] The good thing is that the observer countries must start membership negotiations (accession) within five years of being observers.[259] Currently, all of them are negotiating their WTO membership.[260] For example, Russia and Yemen were WTO observer countries. Both started their membership

[257] US International Trade Commission, *Probable Economic Effect of Modifications to DR-CAFTA Rules of Origin and Tariffs for Certain Apparel Goods*, Investigation No. DR-CAFTA-103-16, Report No. USITC/PUB-3946 (USITC Publication 3946, Washington DC 2007) 2-6.
[258] World Trade Organization, 'Members and Observers' (n 27).
[259] With the exception of the Vatican. Ibid.
[260] World Trade Organization, 'WTO Members and Accession Candidates' (2013) <http://www.wto.org/english/thewto_e/acc_e/members_brief_e.doc> accessed 23 August 2014.

negotiations and then became WTO member countries in 2012 [261] and 2014, [262] respectively. Accordingly, the number of WTO member countries is increasing, which means that more countries would comply with the WTO disciplines and principles. As for the countries that are neither WTO members nor observers, they are urged to join the WTO. After all, the WTO aims to liberalize trade and make it transparent.

e. Conclusion.

Even though the harmonization of non-preferential rules of origin has not been yet completed, there have been progress and ongoing negotiations to complete the harmonization, as clarified above.[263] To not stall such progress, cooperation between WTO member countries is needed. Moreover, all of the suggestions, arguments and analysis mentioned so far in this section should be taken into consideration by the WTO Committee on Rules of Origin to achieve not only a harmonized set of non-preferential rules of origin, but also a rational one. Once non-preferential rules of origin are harmonized, they will be integrated into the Agreement of Rules of Origin as an annex, and the contracting parties will consequently have to carry them out from the enforcement date specified by the Ministerial Conference. Thereupon, the origin of the product will be determined according to a clear substantial transformation norm where the change in tariff classification method will be applied, when more than one country is involved in the production of the good, and supplemented by the value content and/or the specific manufacturing operation tests.

[261] The eighth Ministerial Conference in Geneva approved the accession of Russia on December 16, 2011. On August 22, 2012, Russia became the 156th WTO member country. See World Trade Organization, 'Russian Federation' (2014) <http://www.wto.org/english/thewto_e/acc_e/a1_russie_e.htm> accessed 23 August 2014.

[262] The ninth Ministerial Conference in Bali approved the accession of Yemen on December 4, 2013. On June 26, 2014, Yemen became the 160th WTO member country. See World Trade Organization, 'Yemen' (2014) <http://www.wto.org/english/thewto_e/acc_e/a1_yemen_e.htm> accessed 23 August 2014.

[263] E-mail from Pierre de Vaucher to author (9 January 2009), on file with author.

Having a single regular set of non-preferential rules of origin would not allow WTO member countries to impose rules of origin that suit their interests and protect their national susceptible goods, and would consequently end possible disputes. In addition, customs administrations worldwide would not face any more dilemmas caused by a variety of rules of origin imposed differently by each WTO member country. Further, non-preferential rules of origin would no longer be considered as a nightmare for producers and traders all over the world.

3.2 Harmonizing Preferential Rules of Origin.

During the Uruguay Round, the harmonization of preferential rules of origin was proposed.[264] Subsequently, the Agreement on Rules of Origin in Annex II lays down a few principles that the WTO member countries must comply with when imposing rules of origin, whether in autonomous or contractual trade regimes.[265] In 2010, the EU successfully harmonized and simplified its GSP rules of origin.[266] In December, 2013, at the ninth Ministerial Conference in Bali, WTO ministers adopted the "Bali Package" which consists of a several decisions aimed at lowering trade barriers and facilitating trade for least developed countries.[267] One of the decisions is on preferential rules of origin for least developed countries.[268] The decision lays down

[264] Luc De Wulf and Jose B Soko (eds), *Customs Modernization Handbook* (The World Bank, Washington DC 2005) 188.
[265] These principles were discussed in Chapter I.
[266] Commission Regulation (EU) No 1063/2010 of 18 November 2010 amending Regulation (EEC) No 2454/93, laying down provisions for the implementation of Council Regulation (EEC) No 2913/92 establishing the Community Customs Code [2010] OJ L307/1.
[267] Bali Ministerial Declaration (7 December 2013) WT/MIN(13)/DEC <http://wto.org/english/thewto_e/minist_e/mc9_e/balipackage_e.htm> accessed 23 August 2014.
[268] Preferential Rules of Origin for Least-Developed Countries (7 December 2013) WT/MIN(13)/42 or WT/L/917 <https://docs.wto.org/dol2fe/Pages/FE_DownloadDocument.aspx?Symbol=WT/L/917&Language=English&CatalogueId=125359&Context=ShowParts> accessed 23 August 2014.

certain guidelines to be followed by preference-giving countries for the application of preferential rules of origin to imports coming from least developed countries in autonomous trade regimes. According to the guidelines of Bali decision, such preferential rules of origin "should be as transparent and simple as possible".[269] Moreover, when it comes to the methods for determining origin, the change in tariff classification, if applied, should be done at the tariff heading or sub-heading level.[270] As for the application of the value content, the decision clarifies that the percentage of non-originating inputs used to produce the final good should not exceed 75% of the final product (import value content), and the non-originating inputs are to be valued at the CIF price.[271] Also, according to the Bali decision, the application of the specific manufacturing operation method should be as simple as possible and take into consideration the production capabilities and the development levels of the least developed countries.[272]

Unfortunately, India did not support the implementation of the Bali Package. The decision of the Bali Package on public stockholding for food security purposes

[269] World Trade Organization, 'Steps agreed on implementing Bali decision on rules of origin for LDCs' (n 219).
[270] Ibid.
[271] The Bali decision did not directly specify that the value of the non-originating inputs should be valued at the CIF price. However, the decision provides: "in case of methods used for calculation of foreign inputs, Members may exclude costs related to freight and insurance as well as international transportation costs. In case of methods used for calculation of local/domestic content, Members may include national or regional inland transportation costs." Thus, this implies using the CIF price to value the non-originating inputs. The CIF valuation means that all costs (including the insurance and freight) incurred to send the inputs to the importing country's port are regarded as non-originating and all subsequent costs, like inland transportation, are regarded as originating.
[272] World Trade Organization, 'Preferential Rules of Origin for Least-Developed Countries' (n 268).

was difficult for India to agree to.[273] Subsequently, the WTO member countries agreed to find a permanent solution to that issue by 2017.[274]

The Bali decision on preferential rules of origin for least developed countries is a breakthrough for the WTO because it reflects the WTO member countries' multilateral recognition of the need to simplify preferential rules of origin and impose them pursuant to the production capacities of the exporting countries. That is why many have supported the harmonization of preferential rules of origin and many see that it is of crucial importance.

According to some opinions, harmonized non-preferential rules of origin would lead toward harmonized preferential rules of origin because they would supply preferential rules of origin with a good model for harmonization. However, the harmonization of preferential rules of origin should be done in a different way because each of the methods for determining origin has its benefits and drawbacks, so certain steps should be taken to avoid the drawbacks when harmonizing preferential rules of origin for the sake of trade facilitation, transparency and speeding the process of harmonization.

Most preferential trade agreements have certain elements or rules in common, like the definitions, neutral elements and the list of wholly-obtained goods. Besides, consensus on most of these elements by all WTO member countries' delegates was confirmed during one of their meetings, with the technical committee on rules of origin discussing a draft of harmonized non-preferential rules of

[273] This is a highly sensitive matter for India "given the outlay on its food programme and promises made to the people on the Food Security Act". For more information see World Trade Organization, 'Memorandum Submitted by Dr Ashwani Mahajan from the Swadeshi Jagran Foundation on behalf of people of India' (2013) Position papers provided by NGOs for the Ministerial Conference <http://www.wto.org/english/thewto_e/minist_e/mc9_e/ngo_e.htm> accessed 10 August 2014.
[274] World Trade Organization, 'Days 3, 4 and 5: Round-the-clock consultations produce 'Bali Package'' <http://www.wto.org/english/news_e/news13_e/mc9sum_07dec13_e.htm> accessed 10 August 2014.

origin.[275]Consequently, harmonizing such elements in the WTO system would be an easy task to accomplish. On the other hand, there are some differences that exist between the rules of origin of preferential trade agreements, therefore requiring cooperation between the WTO member countries in order to harmonize them.

a. Commonalities.

The elements that are common to preferential rules of origin include the following:

- General definitions;
- List of wholly obtained or produced goods;
- Insufficient or minimal operations or processes that do not confer origin;
- Neutral elements;
- Consignment criteria;
- Certificate of origin;
- Denial of preferential tariff treatment;
- Claim for preferential tariff treatment;
- Administrative arrangements relating to issue and verification of certificate of origin.[276]

b. Differences.

The factors that the rules of origin of preferential trade agreements do not, in most cases, have in common are: (1) the calculation of the numerator and the denominator used; (2) product-specific rules of origin; (3) cumulation rules; and (4)

[275] Minutes of the Meeting of 19 April 2002 (2002) G/RO/M/40 <http://www.wtocenter.org.tw/SmartKMS/fileviewer?id=7922> accessed 10 August 2014.
[276] Ratna (n 226) 87.

the basic origin method to be applied under the last substantial transformation norm. Each of these will be discussed in turn.

3.2.1 The Calculation of the Numerator and Using the Denominator.

Using the ex-works price as the denominator, the CIF price to value the imported inputs and the import value content requirement can lay an optimal groundwork not only for the harmonization of non-preferential rules of origin that depend on the value content requirement, but also for the harmonization of preferential rules of origin. Moreover, using the import value content requirement and the CIF price to value the non-originating inputs complies with the Bali decision on preferential rules of origin for least developed countries and is currently applied by many jurisdictions.

3.2.2 Product-Specific Rules of Origin.

Because many outstanding issues surrounding product-specific rules of origin are obstructing the completion of the harmonization process of non-preferential rules of origin, product-specific rules of origin should not be included when harmonizing preferential rules. Otherwise, such harmonization would take many years to be accomplished, as has occurred with the harmonization process of non-preferential rules of origin. For this reason, I completely agree with Ratna when he said:

> "[o]n the services, one can learn from the WTO Harmonization Work Programme. In the context of RTAs,[277] it would be desirable to keep the rules of origin simple and transparent, and preferably without any product-specific rules. Thus, it would be preferable to follow a single set of general rules as qualifying criteria for the not-wholly obtained or produced goods."[278]

It is better and easier to comply with a general rule that clarifies the main criterion to determine the origin of a product under the last substantial norm rather than complying with a list of product-specific rules of origin that contains multiple rules applied to a variety of products. With the exclusion of product-specific rules of origin in preferential trade agreements, rules of origin would be unambiguous, uncomplicated, flexible, and clear for the public, traders, and producers.

3.2.3 Cumulation Rules.

Cumulation is a system applied in preferential trade regimes to increase the sources of inputs used in producing the final product. Cumulation rules treat the inputs imported from a certain country or countries as originating in the country where the final product is made by using the inputs.[279] Consequently, the preferential

[277] Regional trade agreements.
[278] Ratna (n 226) 88.
[279] World Customs Organization, 'Accumulation/Cumulation' (2014) <http://www.wcoomd.org/en/topics/origin/instrument-and-tools/comparative-study-on-preferential-rules-of-origin/specific-topics/study-topics/cum.aspx> accessed 24 August 2014.

status of the final product is not undermined.[280] There are three types of cumulation rules: bilateral, diagonal and full cumulation.[281]

The definition of bilateral cumulation[282] is reflected in its name. It is that type of cumulation taking place between two partners of a bilateral preferential trade agreement in which inputs originating in and imported from one partner of a preferential trade area are regarded as originating in the other partner of the same trade area.[283] For example, the European Free Trade Association (EFTA) consists of four countries: Iceland, Liechtenstein, Norway, and Switzerland.[284] Under the free trade agreement between the Republic of Korea and the EFTA (Korea-EFTA FTA), a producer in Switzerland can produce a bicycle (final product) from wheels (inputs) imported from Korea and then export the bicycle to Norway under preferences,[285] as long as the value of the used Korean and Swiss inputs is not less than 70% of the ex-works price of the bicycle.[286] Accordingly, the wheels were treated as if they were of Swiss origin because a bilateral cumulation took place between the Republic of Korea and the EFTA.[287]

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[280] International Bureau of Fiscal Documentation, *IBFD International Tax Glossary*, (IBFD, 6th edn, Amsterdam 2009) 369.
[281] Kazunobu Hayakawa, 'Impact of Diagonal Cumulation Rule of FTA Utilization: Evidence from Bilateral and Multilateral FTAs between Japan and Thailand' (2014) 32 *Journal of the Japanese and International Economies* 1.
[282] Bilateral cumulation is sometimes called "partial cumulation/accumulation".
[283] World Customs Organization, 'Bilateral Accumulation/Cumulation' (2014) <http://www.wcoomd.org/en/topics/origin/instrument-and-tools/comparative-study-on-preferential-rules-of-origin/specific-topics/study-annex/cum-bil-abs.aspx> accessed 24 August 2014.
[284] European Free Trade association, 'The EFTA States' (2014) <http://www.efta.int/about-efta/the-efta-states> accessed 25 August 2014.
[285] EFTA - Korea Free Trade Agreement (Iceland-Liechtenstein-Norway-Switzerland-Korea) Annex I, Section I: Rules of Origin, Title II: Requirements for "Originating Products", Article 3: Cumulation of Origin (December 2005), entered into force (1 September 2006) <http://www.fta.go.kr/webmodule/_PSD_FTA/efta/1/060217_KEFTA_eng.pdf> accessed 25 August 2014.
[286] Ibid, Annex I, Appendix 2: List of Working or Processing Required to be Carried Out on Non-Originating Materials in Order that the Product Manufactured Can Obtain Originating Status, 41 <http://www.fta.go.kr/webmodule/_PSD_FTA/efta/1/060217_KEFTA_eng.pdf> accessed 25 August 2014.
[287] Arthur Mueller, 'What is Cumulation?' (2006) 2 *EFTA Bulletin* 31.

Diagonal cumulation[288] is applied in multilateral preferential trade regimes between three or more countries.[289] It means that the inputs originating in and imported from one or more members of a multilateral trade regime are regarded as originating in other members.[290] For example, based on the Pan-Euro-Med regime,[291] a cumulation zone is applied between the EU, the EFTA, Turkey, the countries that signed the Barcelona Declaration[292] and the Faroe Islands.[293] Accordingly, if a product was produced in Egypt by using imported inputs from Switzerland (EFTA member), the product would be conferred origin and exported to Germany (EU) under preferences. In this example, the inputs were treated as if they were of Egyptian origin because of the Pan-Euro-Med diagonal cumulation zone.[294]

Full cumulation is the same as diagonal cumulation, but all manufacturing operations carried out in any member of the multilateral agreement are counted as part of the originating content, as if they have taken place in the country where the final product was made, irrespective of whether the manufacturing operations are enough

[288] Diagonal cumulation is sometimes referred to as "regional cumulation/accumulation".
[289] World Customs Organization, 'Diagonal Cumulation' (2014) <http://www.wcoomd.org/en/topics/origin/instrument-and-tools/comparative-study-on-preferential-rules-of-origin/specific-topics/study-annex/cum-dia.aspx> accessed 25 August 2014.
[290] Some countries require that the preferential trade agreements formed between the members of the multilateral agreement must impose identical rules of origin to apply diagonal cumulation. See ibid.
[291] Council of the European Union 9429/10 Regional Convention on Pan-Euro-Mediterranean Preferential Rules of Origin [2010] Interinstitutional File: 2010/0092 (NLE).
[292] Barcelona Declaration and Euro-Mediterranean partnership (European Union-Algeria-Egypt-Israel-Jordan-Lebanon-Morocco-Syria-Tunisia-the Palestinian Authority of the West Bank and Gaza Strip) adopted 28 November 1995 <http://www.eeas.europa.eu/euromed/docs/bd_en.pdf> accessed 25 August 2014.
[293] Full cumulation is applied by the European Economic Area (the EU, Iceland, Liechtenstein and Norway) and between the EU and Algeria, Morocco and Tunisia.
[294] For more details about the Pan-Euro-Med cumulation, see European Commission, 'System of Pan-Euro-Mediterranean Cumulation' (2014) <http://ec.europa.eu/taxation_customs/customs/customs_duties/rules_origin/preferential/article_783_en.htm#specific> accessed 26 August 2014. See also Customs: Council approves new European-Mediterranean cumulation of origin zone [2005] IP/05/1256 <http://europa.eu/rapid/press-release_IP-05-1256_en.htm?locale=EN> accessed 26 August 2014.

to confer origin on the used inputs.[295] For example, currently, there is a full cumulation zone between the EU and Algeria, Tunisia and Morocco.[296] Accordingly, if a men's shirt was produced in Tunisia by sewing fabrics, which were woven from yarn in the EU and imported from there, the shirt would be conferred origin and the weaving manufacturing operation that took place in the EU would be treated as if it was carried out in Tunisia. Consequently, the shirt could be exported to Morocco, Algeria, or the EU under preferences.[297]

Cumulation rules increase the sources of inputs and are considered by many as a trade facilitation tool. However, they can lead to negative results.

It is known that the application of stringent rules of origin in a preferential trade agreement encourages the final good producers to source inputs from inside the preferential trade area. With cumulation rules, final good producers would be induced to source inputs from inside the preferential trade area and the cumulation zone, leading to a case of trade diversion if the internal inputs (goods sourced from inside the preferential trade area and the cumulation zone) are less efficient than those of the external suppliers. Hence, cumulation rules could be used as bait that aims at diverting trade and protecting national industries. For example, the NAFTA applies full cumulation.[298] This means that all manufacturing operations performed in North America by using North American inputs are treated as part of the originating content

[295] World customs Organization, 'Full Cumulation' (2014) <http://www.wcoomd.org/en/topics/origin/instrument-and-tools/comparative-study-on-preferential-rules-of-origin/specific-topics/study-annex/cum-ful.aspx> accessed 26 August 2014.
[296] Explanatory Notes Concerning the Pan-Euro-Mediterranean Protocols on Rules of Origin [2007] OJ C83/3.
[297] Ibid. See also European Commission, 'A User's Handbook to the Rules of Preferential Origin used in trade between the European Community, other European Countries and the countries participating to the Euro-Mediterranean Partnership' 15 <http://ec.europa.eu/taxation_customs/resources/documents/customs/customs_duties/rules_origin/preferential/handbook_en.pdf> accessed 26 August 2014.
[298] North American Free Trade Agreement (n 51) Chapter 4: Rules of Origin, Article 404: Accumulation.

of the final product. Accordingly, trade diversion takes place when Mexican automobile producers source costly inputs from North America (mainly the US) instead of cheaper inputs from external suppliers, to satisfy the high regional value content of 62.5% imposed on the automotive goods.[299]

Barceló put forward similar arguments regarding cumulation rules as trade hindrances.[300] He stated that their role becomes more active the more stringent rules of origin are in a preferential trade agreement because, as a result, internal producers try to satisfy the stringent rules of origin by sourcing inefficient inputs from within the cumulation zone, instead of efficient external ones.[301] Furthermore, Barceló argued that cumulation rules are inconsistent with article XXIV (4) of the GATT since their trade-diverting effects act as obstacles to the trade of external suppliers with the preferential trade area.[302]

The cumulation documentation procedures are also complicated. Sometimes the exporter's government is required to "provide certification", which increases the costs and administrative burdens on the exporter.[303] Also, under full cumulation, the exporter needs to "track back" the manufacturing operations that took place in the countries participating in the full cumulation zone.[304] As a result, detailed information from the inputs sources of supply could be required.[305]

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[299] Jong Bum Kim, 'Regional Harmonization of Preferential Rules of Origin in Asia: In Search of a Minimum Common Denominator' (2009) Paper Submitted to the Asian International Economic Law Network Inaugural Conference, 7.
[300] John J. Barceló III, 'Harmonizing preferential rules of origin in the WTO system' (2006) Cornell Law School Legal Studies Research Paper Series 72, 19-20, 25-26 <http://scholarship.law.cornell.edu/cgi/viewcontent.cgi?article=1071&context=lsrp_papers> accessed 26 August 2014.
[301] Ibid 19.
[302] Ibid 26.
[303] Erlinda M. Medalla and Jenny Balboa, 'ASEAN Rules of Origin: Lessons and Recommendations for Best Practice' (2009) Economic Research Institute for ASEAN and East Asia Discussion Paper Series, Philippine Institute for Development Studies (PIDS), Philippines, 10.
[304] World Customs Organization, 'Accumulation/Cumulation' (n 279).
[305] Paul Brenton, 'Preferential Rules of Origin' (n 250) 167.

Based on these arguments, the application of cumulation rules should not be applied in preferential trade regimes.

3.2.4 The Basic Required Origin Method to be applied under the Last Substantial Transformation Norm.

The HS was not really designed for origin specification purposes. That is why when the change in tariff classification is applied as the main origin determination criterion, it may be supplemented by the value content requirement and/or specific manufacturing operation methods. Therefore, after detailed study of the HS and different preferential rules of origin, one can think of an alternative to product-specific rules of origin by dividing the origin-conferring operations into four categories;

1. Operations that need a change in tariff classification, at which the value content requirement is imposed as well, but as an optional criterion;
2. Operations that need the value content requirement to be the sole criterion applied;
3. Operations that require a specific manufacturing operation, at which the value content requirement is imposed, but as an optional criterion; and
4. Operations that require one of the three origin determination methods to be complied with (the value content requirement/ the change in tariff classification/ the specific manufacturing operation).

It follows that the value added criterion is the only method that is applied in all of the three categories for classifying origin proposed above. That is simply because

the value added method can confer origin on any product,[306] unlike the change in tariff classification. As a result, the value added method, in the proposal for harmonizing preferential rules of origin in this chapter, will be the main method relied on when determining origin.

When it comes to the percentage of the value added, it is suggested to impose a maximum of 60% import value content for WTO member countries, but 75% for WTO least developed member countries. The figure of 60% is suggested as being a realistic compromise between different interests. While the 60% is quite sufficient for some product sectors to comply with to prove origin (as in the automotive sector), it could still be too stringent for some other sectors (e.g. textiles).[307] However, one should not forget that the value added in a lot of sectors would be an alternative to the other two methods of determining origin. Nevertheless, complying with a fixed percentage imposed on all products is general, not confusing and does not engender product-specific rules of origin. Sometimes protectionist intentions aim for the imposition of a percentage that is even lower than 60% import value content.[308] As for the 75% value content requirement for least developed countries, it was adopted at the Ninth WTO Ministerial Conference in Bali, as mentioned above, and therefore should not be a problem for WTO member countries to agree on.

When it comes to the specific manufacturing operation, the *positive* test should be applied as an *alternative* (not mandatory) criterion for either the value added content only or both the change in tariff classification and the value added. The

[306] Even the wholly-obtained goods are considered to be of a 100% value added. See Thinam Jakob and Gernot Fiebiger, 'Preferential rules of Origin - a conceptual outline' (2003) 38 *Intereconomics* 138, 140.
[307] Biswajit Nag (n 34), 8.
[308] The yarn forward rule of origin imposed in the NAFTA "virtually amounts to a 100% value-added", which is similar to the imposition of 0% import value content. See Rupa Duttagupta and Arvind Panagariya, 'Free Trade Areas and Rules of Origin: Economics and Politics' (2007) 19 *Wiley Blackwell* 169, 190.

reason for using the positive test as an alternative criterion is to reduce the possibilities for engendering specific exceptional rules of origin that might take a long time to agree on, as has happened concerning the harmonization of non-preferential rules of origin.[309] Also, the positive test is more flexible than the negative test, so this will not leave much possibility for imposing too stringent protectionist rules of origin. Moreover, when the harmonization of preferential rules of origin takes place, any country with protectionist intentions will understand that there is an alternative criterion that may be complied with no matter how stringent the test could be, which will, to a great extent, counter protectionist intentions as well.

Article 3 (b) of Annex II of the Agreement on Rules of Origin provides: "The Members agree to ensure that: . . . their preferential rules of origin are based on a positive standard. Preferential rules of origin that state what does not confer preferential origin (negative standard) are permissible as part of a clarification of a positive standard or in individual cases where a positive determination of preferential origin is not necessary". In other words, the manufacturing operation rule of origin shall clearly define what does confer origin (positive test) instead of what does not confer origin (negative test).[310] The specific manufacturing operation method based on the positive standard should be enough to explain any technicality or process that a certain product should undergo. Also, the positive standard is not as stringent as the negative one in most cases and is not as commonly used for protectionist purposes as the latter.[311] That is why the manufacturing operation method based on the positive standard would be used as an alternative method in the proposed harmonized preferential rules of origin. In addition, since the specific manufacturing operation

[309] It was mentioned previously that out of the 94 outstanding issues obstructing the harmonization of non-preferential rules of origin, 83 are related to product-specific rules of origin. It was also clarified that the specific manufacturing operations test could engender product-specific rules of origin.
[310] Bossche and Zdouc (n 148) 462.
[311] Paul Brenton, 'Preferential Rules of Origin' (n 250) 164.

method sometimes requires a lot of technicality, a separate attachment should include all origin-conferring manufacturing operations, for the sake of transparency and simplification. Accordingly, final goods producers would be able to choose: whether to comply with the specific manufacturing operation mentioned in the attachment or the other origin determination method(s).

Based on all of the previously-clarified information, the proposed harmonized preferential rules of origin are presented as follows:

3.2.5 Proposed Harmonized Set of Preferential Rules of Origin.

1- <u>DEFINITIONS</u>

These are general definitions illustrating the kinds of manufacturing operations and explaining terms, like “material”, “originating material”, non-originating material” and “Customs Valuation Agreement”.

2- <u>GENERAL RULES</u>

These rules:

(i) Explain the classification of goods within the harmonized system;

(ii) Clarify that the determination of origin shall comply with the general rules;

(iii) Explain the neutral elements that are not part of the final good and, thus, not regarded as originating, like fuel, plant, and safety equipment used in the production;

(iv) Disregard the origin of the packing and packaging and containers that the goods are presented in;

(v) Disregard the origin of the accessories, spare parts and tools used to produce the goods; and

(vi) Disregard minimal operations and processes when determining the origin of the good, like preserving the good in a good condition; facilitating shipping or transporting it; and presenting it for sale.

3- WHOLLY OBTAINED GOODS

This section defines the goods that are regarded as wholly obtained in one country, like animals born, raised, hunted, fished, or captured in one country; plants harvested in that country; or minerals obtained from there.

4- ORIGIN DETERMINATION

a- Origin shall be conferred when the products that are classified under certain chapters of the HS are wholly obtained in the country of export (for example, chapters 1, 7, 8 and 10).

b- Origin shall be conferred when a change in tariff classification at the *chapter* level occurs; or when a maximum import value content of 60%, or 75% for least developed countries, is complied with for products classified under certain chapters of the HS (for example, chapters 5, 16-17 and 42).

c- Origin shall be conferred when a change in tariff classification at the *heading* level occurs; or when a maximum import value content of 60%, or 75% for

least developed countries, is complied with for products classified under certain chapters of the HS (for example, chapters75 and 76).

d- Origin shall be conferred when a change in tariff classification at the *sub-heading* level occurs; or when a maximum import value content of 60%, or 75% for least developed countries, is complied with for products classified under certain chapters of the HS (for example, chapters 4, 29, 35 and 84).

e- Origin shall be conferred when a maximum import value content of 60%, or 75% for least developed countries, is complied with for products classified under certain chapters of the HS (for example chapters 72, 85, 87).

f- Origin shall be conferred when a specific manufacturing operation based on the positive standard has been carried out; or a maximum import value content of 60%, or 75% for least developed countries, is complied with for products under certain chapters of the HS (for example, chapters 73 and 90).

g- Origin shall be conferred when a specific manufacturing operation based on the positive standard has been carried out; or a change in tariff classification takes place; or a maximum import value content of 60%, or 75% for least developed countries, is complied with for certain products classified under the HS (for example, chapters 15, 50 and 54-63).

3.2.6 Commentary on the Proposal.

As may be seen, the proposed harmonized set of preferential rules of origin is based on general terms and presented in a simple manner that is not too flexible or too stringent. No product specific rules of origin are presented and no negative standards are imposed. Moreover, the specific manufacturing operation method is used as

alternative method for origin determination. Two things must be taken in to account though; first, the import value content requirement should comply with EU standards; second, a separate attachment clarifying the alternative positive manufacturing operations should be given To Whom It May Concern, such as a trader, producer or importer.

One might wonder about the level at which the change in tariff classification shall be made. According to the proposal, the level of the tariff classification is left to be agreed on by the WTO members. Countries could reach consensus easily when there is more than one optional rule to be used. For example, some countries might want to impose a rule of origin that requires a change in tariff classification at the chapter level which might be stringent for others, but the latter might agree as long as there was available alternative rule to comply with.

In summary, the proposed harmonized set of preferential rules of origin should ensure the following:

1- A wise application of preferential origin rules that are not too stringent to be used for protectionist, trade-diverting or political purposes;
2- The complete elimination of the spaghetti bowl effect on preferential rules of origin;
3- Alternative criteria between which a producer would always be able to choose instead of the mandatory three rules to be complied with in some current agreements;
4- Least developed countries would be supported and there should be an increase in their utilization of preferences[312];
5- Fair competition, since no protectionist rules of origin would be imposed;

[312] It was already explained in chapter II how some countries' producers forgo the utilization of preferences because of the imposition of stringent rules of origin.

6- The efficiency of global production would be boosted, since no trade diversion would take place because of the harmonized preferential rules of origin;

7- More choice for consumers; and last but not least,

8- A real liberalization of trade.

In the next chapter, the proposed harmonized set of preferential rules of origin will be tested to try to prove the truth of these assertions.

By following all of the previously mentioned arguments of this part, efforts to harmonize preferential and non-preferential rules of origin would result in success to a considerable extent. However, there are other points that should be taken into account concerning the harmonization of both preferential and non-preferential rules of origin.

Tolerance rules are contrary to cumulation rules because they allow sourcing a fixed magnitude of inputs from anywhere in the world without affecting the origin of the final product leading to no trade diversion.[313] That is why increasing the scope of tolerance rules would facilitate trade and thus needs to be taken into account when harmonizing preferential rules of origin.

Moreover, the interests of developing countries should be taken into consideration when harmonizing both non-preferential and preferential rules of origin. Besides, developing countries should know that countries with big markets, like the US and the EU usually request their industries to present proposals concerning the harmonization process of non-preferential rules of origin, which might lead to some protectionist implementations. Consequently, this could happen when harmonizing preferential rules of origin. Developing countries should be aware of this risk because there will be no turning back once both types of rules of origin are harmonized.

[313] Barceló III (n 300) 34.

3.2.7 The Position of WTO Member Countries.

This section shows that the proposed harmonized set of preferential rules of origin is in line with what is actually happening in preferential trade agreements and therefore makes the proposal more politically acceptable. Although the preferential trade regimes, discussed below, represent large trading blocs around the world, they are only a tiny proportion of preferential trade agreements, but for reasons of space it is not possible to discuss more agreements. Therefore the proposed harmonized set of preferential rules of origin could be controversial among WTO member countries.

The ASEAN FTA (AFTA) relies mainly on the value added criterion which is "a regional value content of not less than 40 percent".[314] In other words, a maximum import content of 60 %. The agreement was formed between least developed countries (Myanmar, Cambodia and Laos), developing countries (Indonesia, Philippines, Thailand, Malaysia and Vietnam) and developed countries (Brunei and Singapore).[315] The AFTA rules of origin are easy to understand, unambiguous and precise. They are close to the harmonized preferential rules of origin proposed above. The AFTA contains product-specific rules of origin relying on the mentioned value added criterion and uses the specific manufacturing operation method as an alternative criterion, but latter is also imposed *sometimes* in its negative form. However, according to the proposed rules in this chapter, rules of origin are presented

[314] Agreement on the Common Effective Preferential Tariff (CEPT) Scheme for the ASEAN Free Trade Area (AFTA) (Brunei Darussalam-Cambodia-Indonesia-Lao People's Democratic Republic-Malaysia-Myanmar-Philippines-Singapore-Thailand-Viet Nam) Annex 3: Product Specific Rules of Origin Rules of Origin (28 January 1992) entered into force 1 January 1993 <http://www.asean.org/images/archive/20750.pdf> accessed 10 August 2014.
[315] Association of South East Asian Nations, 'ASEAN Member States' <http://www.asean.org/asean/asean-member-states> accessed 10 August 2014.

in a simpler way and the manufacturing operation test could be used as an alternative criterion as well, but *always* in its positive form (as shown later).

The ASEAN-Australia-New Zealand FTA (AANZFTA) is similar to the AFTA, also relying on a 40% local value content requirement to be complied with.[316] Moreover, since there are proposals to form the ASEAN + 6 FTA, which might be really soon, more developing and developed countries would be complying with the mentioned AFTA rules of origin (China, India, Japan, Australia, South Korea and New Zealand).[317]

It is worth mentioning as well that the APTA (known previously as the Bangkok Agreement) imposes simple rules of origin relying on 55% import value content and 65% for least developed countries, which is, again, very close to the proposed rules of origin in this chapter.[318] The APTA members are Bangladesh, China, India, South Korea, Laos and Sri Lanka,[319] which is also an example reflecting a good partnership between countries.[320]

On November 18, 2010, the European Commission adopted a regulation that reformed, simplified and harmonized its rules of origin imposed under the GSP regime.[321] The new EU rules of origin are transparent since they rely mostly on a maximum of 50% import content that shall be complied with under the GSP regime,

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[316] ASEAN-Australia-New Zealand Free Trade Agreement (ASEAN-Australia-New Zealand) Annex II – Product Specific Rules of Origin (27 February 2009) entered into force 1 January 2010 <http://www.asean.fta.govt.nz/annex-2-product-specific-rules/> accessed 10 August 2014.

[317] Petchanet Pratruangkrai, 'Economic ministers agree to establish Asean+6 FTA by 2015' (2013) The Nation <http://www.nationmultimedia.com/business/Economic-ministers-agree-to-establish-Asean+6-FTA--30213274.html> accessed 10 August 2014.

[318] Asia-Pacific Trade Agreement (People's Republic of Bangladesh, the People's Republic of China, the Republic of India, the Lao People's Democratic Republic, the Republic of Korea and the Democratic Socialist Republic of Sri Lanka) Annex II: Rules of Origin for the Asia-Pacific Trade Agreement, Rule 3: Not Wholly Produced or Obtained and Rule 10: Special Criteria Percentage (2 November 2005) entered into force 1 September 2006 <http://fta.mofcom.gov.cn/yatai/xieyiwenben_en.pdf> accessed 10 August 2014.

[319] ESCAP, 'Asia-Pacific Trade Agreement Member Countries' <http://artnet.unescap.org/APTIAD/viewagreement.aspx?id=APTA> accessed 10 August 2014.

[320] ESCAP, *Trade-led Recovery and Beyond*, Asia Pacific Trade and Investment Report, (New York and Bangkok: United Nations, 2009) Ch3, 115.

[321] Commission Regulation (EU) No 1063/2010 (n 266).

but a 70 % for least developed countries. The new EU rules of origin are not really much different from the proposed value content percentage mentioned in this chapter. The main difference could be eliminated by changing the 50% to 60% for all WTO member countries to comply with, and not only developing countries. The reason to do that is simple; 50 % is too stringent to be generally imposed on a lot of products, especially for developing countries.[322] To do so would be the same as the rule of origin imposed on most sectors in the AFTA: "*A regional value content of not less than 40 percent*". In other words, a maximum import content of 60%. The reason a comparison is made here between the two rules is because the AFTA rules of origin are easy to understand, comply with and are imposed in an agreement formed, as mentioned by least developed, developing and developed countries. These countries were able to sit together and agree.

Surprisingly, the US and Russia expressed interest in and support for the ASEAN.[323] In October, 2010, they were officially accepted to be granted seats in the East Asia Summit.[324] The US and Russia took such step because the ASEAN members succeeded in increasing "their political and economic importance" by facilitating trade with each other.[325] This type of cooperation can be witnessed a lot in the preferential trade field. That is why; extensive collaboration between many WTO member countries could exist during the harmonization of preferential rules of origin.

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[322] An editorial comment, 'EU agrees new rules of origin' (2010) Agritrade <http://agritrade.cta.int/en/layout/set/print/Agriculture/Topics/Other/EU-agrees-new-rules-of-origin> accessed 10 August 2014.
[323] Association of South East Asian Nations, 'ASEAN Secretary-General Visits Russia' (2014) <http://www.asean.org/news/asean-secretariat-news/item/asean-secretary-general-visits-russia > accessed 10 August 2014.
[324] Wilhelm Hofmeister, 'From the Driver's Seat to the Backseat - Regional Cooperation in Southeast Asia' (2011) 4 *International Reports of the Konrad-Adenauer-Stiftung* 145.
[325] Pavin Chachavalpongpun (ed), *Asean-U.S. Relations: What are the Talking Points?* (Institute of South East Asian Studies, Singapore 2012) 19.

The following table shows some of the existing preferential trade agreements relying on the value added criterion:

Agreements	Main Criterion for determining Origin	The percentage of the value content
AFTA	Value Added	40% local value content
APTA	Value Added	55% import value content 65% import value content for least developed countries
EU GSP	Value Added	50% import value content 70% import value content for least developed countries
AANZFTA	Value Added	40% local value content
ASEAN - China[326]	Value Added	40% local value content
SAPTA (South Asian Association for Regional Cooperation Preferential Trading Agreement) [327]	Value Added	60% import value content
Singapore – Australia[328]	Value Added	50 % local value added

[326] China-ASEAN Free Trade Agreement (ASEAN-China) Annex 3, Rule 4: Not Wholly Produced or Obtained (4 November 2002), entered into force 1 January 2010 <http://www.asean.org/images/2013/economic/afta/ACFTA/3-%20ACFTA%20TIG%20Annex%203.pdf> accessed 10 August 2014.

[327] SAARC Preferential Trading Arrangement (SAPTA) (Afghanistan-Bangladesh-Bhutan-India-Maldives-Nepal-Pakistan-Sri Lanka) Annex III, Rule 3 : Not Wholly Produced or Obtained (11 April 1993), entered into force 7 December 1995 <http://saarc-sec.org/uploads/document/SAPTA%20Agreement_20110812120334.pdf> accessed 17 August 2014.

[328] Singapore-Australia Free Trade Agreement (Singapore-Australia) Annex 3, Article 3: Originating Goods (17 February 2003), entered into force 28 July 2003 <http://wits.worldbank.org/GPTAD/PDF/archive/Singapore-Australia.pdf> accessed 10 August 2014.

Source: Author's Analysis

It is not clear yet what kinds of rules of origin the APEC FTA is going to have when it is formed, but many of the ASEAN and ASEAN+6 member countries are APEC members.[329] The preferences of the ASEAN member countries when it comes to imposing rules of origin are for such rules to be simple, clear, and straight-forward. This gives hope that clear and flexible rules of origin will be applied in one of the biggest possible FTAs in the world to be formed.

The Transatlantic Trade and Investment Partnership (TTIP)[330] is a proposed trade agreement to be established between the US and the EU by the end of 2014.[331] The possible rules of origin to be applied in this very large FTA are not yet known, but it is to be hoped that the agreement will avoid the imposition of rules of origin that could obstruct trade in one of the largest future FTAs worldwide.[332]

3.2.8 The Prospects for Agreement on Harmonized Preferential Rules of Origin.

Non-preferential rules of origin were supposed to have been harmonized by 1998. That deadline has been missed by many years. Moreover, there still remain a large number (94) of issues to resolve, including many of the most difficult issues. The fact that the WTO operates through consensus and that it has a large and very diverse membership make it very hard to agree on anything. This explains why the

[329] APEC, 'Member Economies' (n 190).
[330] European Commission, 'What is the Transatlantic Trade and Investment Partnership (TTIP)?' (2014) <http://ec.europa.eu/trade/policy/in-focus/ttip/about-ttip/> accessed 10 August 2014.
[331] European Commission, 'State of Play of TTIP negotiations after the 6th round' (2014) <http://trade.ec.europa.eu/doclib/docs/2014/july/tradoc_152699.pdf> accessed 10 August 2014. See also Grant Eyster, 'Trans-atlantic Free Trade Area' (2013) Indiana University College of Arts and Sciences Bloomington, European Union Center, Policy Brief, 1.
[332] Stormy-Annika Mildner and Claudia Schmucker, 'Trade Agreement with Side-Effects?' (2013) German Institute for International and Security Affairs, SWP Comments 18, 6.

Doha process has become virtually deadlocked. Even the Bali agreement, which supports a lot of points discussed in this chapter, is now threatened by opposition from India. Furthermore, at the Committee on Rules of Origin meeting in September, 2013, Canada, Australia and the US stated that they do not believe anymore that the harmonization of non-preferential rules of origin would be trade facilitating.[333]

Nevertheless, there are reasons for optimism. Having seen earlier that the value added method is used as the main criterion for determining the origin of goods in many preferential trade regimes, there would seem to be a good possibility for implementing the proposed harmonization of preferential rules of origin.

The Bali Package comprises about 16 decisions.[334] India's refusal to support the Bali Package is not related to the decision on preferential rules of origin for least developed countries, but to the decision on public stockholding for food security purposes.[335] This means that all WTO member countries agree on the application of the 75% import value content requirement for least developed countries, which conforms to the proposed harmonized set of preferential rules of origin discussed in this chapter. Moreover, the WTO member countries agreed to find a permanent solution to India's issue by 2017, which could lead to the implementation of Bali Package by then.[336]

During the Committee on Rules of Origin meeting in September, 2013, a lot of countries did not agree with the views of Canada, Australia and US referred to above. India, the EU, China, Switzerland and Chinese Taipei expressed their interest in

[333] World Trade Organization, 'Members divided on way forward for rules of origin' (2013) <http://www.wto.org/english/news_e/news13_e/roi_26sep13_e.htm> accessed 10 August 2014.
[334] For full details of these decisions, see World Trade Organization, 'Ministerial Declaration and Decisions' (2013) <http://wto.org/english/thewto_e/minist_e/mc9_e/bali_texts_combined_e.pdf> accessed 10 August 2014.
[335] World Trade Organization, 'Days 3, 4 and 5: Round-the-clock consultations produce 'Bali Package'' (n 274).
[336] Ibid.

completing the harmonization of non-preferential rules of origin. India described the different rules of origin applied by different countries as a "jungle" and stressed the importance of harmonizing non-preferential rules of origin because of the difficulties that its exporters currently face.[337]

The Technical Committee on Rules of Origin has been arranging meetings up to the present with WTO member countries' delegates to try to solve the outstanding issues of non-preferential rules of origin.[338] From 486 outstanding issues, 94 core policy outstanding issues remain to complete the harmonization of non-preferential rules of origin.[339] The harmonized non-preferential rules of origin so far are flexible and transparent compared to the stringent rules of origin discussed in Chapter II. Moreover, the harmonization of non-preferential rules of origin could serve as a model for the harmonization of preferential rules of origin and vice-versa.

Preferential rules of origin are used to determine the country of origin of the product to decide whether to accord preferences to that product. However, non-preferential rules are used for implementing trade policy instruments, labelling requirements, gathering trade statistics and government procurement. That is why preferential rules of origin are easier to negotiate.

The fact that the spaghetti bowl phenomenon was triggered by the proliferation of preferential rules of origin worldwide and the increase in the administrative burdens that traders face made a lot of companies aware of the need to harmonize preferential rules of origin.[340] While the number of WTO member countries is

[337] World Trade Organization, 'Members divided on way forward for rules of origin' (n 333).
[338] Minutes of the Meeting of 18 April 2013 (2013) G/RO/M/60, this is a restricted document, but on file with the author.
[339] World Trade Organization, 'Agreement on Rules of Origin' (n 209).
[340] International Chamber of Commerce, 'ICC World Trade Agenda Post-Bali Business Priorities' (2014) Paper Prepared by the ICC Commission on Trade and Investment Policy, 6 <http://www.iccwbo.org/Advocacy-Codes-and-Rules/Document-centre/2014/ICC-WORLD-TRADE-AGENDA-Post-Bali-Business-Priorities/> accessed 10 August 2014.

currently 160,[341] the number of preferential trade agreements notified to the WTO is 585.[342] Consequently, the academic field and literature are more focused on the preferential arena and the spaghetti bowl.[343]

With an understanding of the political incentives for harmonization and of sensitive industrial sectors, countries could somehow reach a compromise. The suggested proposal for harmonizing preferential rules of origin might not be perfect for some countries, but it could definitely serve the process of harmonization of either non-preferential or preferential rules of origin. The guidelines mentioned in this chapter are of extreme importance and should be taken into consideration at least.

Finally, the WTO member countries should seriously discuss the completion soon of the harmonization work programme and the harmonization of preferential rules of origin during the Doha round in order to overcome the negative effects resulted from the misuse of rules of origin.

[341] World Trade Organization, 'Members and Observers' (n 27).
[342] World Trade Organization, 'Regional Trade Agreements' (n 29).
[343] Antoni Estevadeordal and Kati Suominen, 'Rules of Origin: A World Map and Trade Effects' (2004) Paper prepared for the Seventh Annual Conference on Global Economic Analysis: Trade, Poverty, and the Environment, 66.

CHAPTER IV

TESTING THE PROPOSED MODEL FOR HARMONIZED PREFERENTIAL RULES OF ORIGIN

Chapter III came up with a proposed harmonized set of preferential rules of origin. This Chapter (IV) tests the proposal in order to evaluate its efficiency in overcoming the negative effects of non-harmonized preferential rules of origin that were discussed in Chapter II that resulted from the misuse of such rules of origin.

Testing the harmonized set is going to be done by comparing two scenarios. The first is the *status quo*. In other words, the preferential trade agreements as they are, currently, without a harmonized set of preferential rules of origin. The second is the possible impact of harmonizing preferential rules of origin in the WTO system by applying the proposed set of rules to certain preferential trade regimes.

Since the harmonization of preferential rules of origin in the WTO system has not been accomplished until now, applying the harmonized set of preferential rules of origin is going to be theoretical. Also, to make things easy for the reader, the author in this chapter is going to apply the proposed set of rules to some of the trade regimes discussed in Chapter II, i.e. the North American Free Trade Agreement (NAFTA), the Qualified Industrial Zones (QIZs) and the Asian-Pacific Economic Cooperation (APEC).

4.1 Protectionism.

Rules of origin have been used for protectionist purposes in some preferential trade regimes. This happens because countries are free to apply too stringent preferential rules of origin for the purpose of protecting their own national interests. The proposal for harmonization lays down limits on the level of stringency of such rules. As discussed in Chapter II, the imposition of protectionist rules of origin can take three forms: (1) requiring producers to comply with more than one origin determination method; (2) requiring producers to comply with a stringent value content requirement; and (3) requiring producers to comply with a stringent manufacturing operation based on the negative standard. However, the proposed harmonized rules would allow producers to choose which method of origin determination to comply with. Moreover, the value content percentage requirement in the proposal is not too stringent and takes into account the production capacities of least developed countries. Furthermore, the specific manufacturing operation method is based on the positive standard, rather than the negative one. Adopting the harmonized set of rules would not give large firms the chance to lobby for the application of too stringent protectionist preferential rules of origin.

An example will now be discussed, drawn from the discussion in Chapter II, to illustrate this point. The NAFTA imposes a very stringent and protectionist 62.5% regional value content requirement on automotive goods. The 62.5% here equals a maximum import content of 37.5%. Big US automakers pushed the US government to impose the too stringent 37.5% import value content in order to be protected from

Japanese and German competitors established in North America.[344]The change in tariff classification method cannot be relied on to confer origin for automotive goods. That is why the NAFTA relied on the value content requirement. The following two tables illustrate the case before and after the imposition of the proposed harmonized preferential rules of origin:

- **Before (the NAFTA as it is):**

Chapter	Tariff heading	Tariff Sub-heading	Tariff Item	Product description	Rule of Origin
87	8702	8702.10	- 8702.10 bb - 8702.90 bb	"vehicles for the transport of 15 or fewer persons"	Import value content of 37.5%

Source: NAFTA

- **After the implementation of the proposed preferential rules of origin:**

Chapter	Tariff heading	Tariff Sub-heading	Tariff Item	Product description	Rule of Origin
87	8702	8702.10	- 8702.10 bb - 8702.90 bb	"vehicles for the transport of 15 or fewer persons"	A maximum import value content of 60% and 75% for least developing countries

Source: Author's Analysis

[344] Vivian C. Jones and Michaela D. Platzer, 'The Proposed U.S.-South Korea Free Trade Agreement (KORUS FTA): Automobile Rules of Origin' (2011) Congressional Research Service R41868, 7.

One can easily appreciate the main difference between the two tables. The import value content specified in first table allows for the utilization of a maximum 37.5 % imported materials for the finished product to be conferred origin. However, the second table allows for a maximum of 60% imported materials to be used in producing the good. The 37.5% is not a big deal for the US automaker because they already rely on inputs sourced from the US. However, foreign automakers rely on imported inputs and such a percentage makes it difficult for them to source inputs from outside the North American region. The application of the 60% import value content requirement is more flexible. Therefore, adopting the proposed harmonized set of rules would allow the Japanese, German and Korean automakers to compete fairly with the US automotive industry and no protectionism would take place.

The next example concerns the NAFTA protectionist triple transformation rule of origin. The next two tables demonstrate the difference between the two cases.

- **The current position in NAFTA:**

Chapter	Tariff heading	Product description	Rule of Origin
61	6105 6106	"cotton yarns to woven cotton fabrics; man-made filament yarns to pantyhose; wool yarns to woven wool fabrics to wool apparel."	"A change to heading 61.05 through 61.06 from any other chapter, except from headings Nos. 51.06 through 51.13, 52.04 through 52.12 … provided that the good is both cut (or knit to shape) and sewn or otherwise assembled in the territory of one or more of the NAFTA parties."

Source: NAFTA

- **The NAFTA after implementing the proposal: Two possible scenarios:**

Chapter	Tariff heading	Product description	Rule of Origin
61	6105 6106	"cotton yarns to woven cotton fabrics; man-made filament yarns to pantyhose; wool yarns to woven wool fabrics to wool apparel."	A specific manufacturing process based on attachment 1; or a maximum import content of 60% (or 75% for least developed countries)

Source: Author's Analysis

OR

Chapter	Tariff heading	Product description	Rule of Origin
61	6105 6106	cotton yarns to woven cotton fabrics; man-made filament yarns to pantyhose; wool yarns to woven wool fabrics to wool apparel.	A change to heading 61.05 through 61.06 from any other chapter or a maximum import content of 60% (or 75% for least developed countries)

Source: Author's Analysis

The current rule of origin in the first table relies on a negative standard change in tariff classification ("except from headings Nos. 51.06 through 51.13, 52.04 through 52.12 …"). Furthermore, the specific manufacturing operation that is mentioned later on is imposed as a mandatory origin determination criterion. This is an extreme case of stringency. However, if the proposed harmonized rules were applied, there would be two possible scenarios. The first scenario takes into account the technicality and sensitivity of the textile industry. The term "Attachment 1" mentioned in the second table refers to the optional manufacturing process based on a positive standard. Consequently, a producer could choose either the manufacturing process or the value added criterion. The third table utilizes the criterion of change in tariff classification that the NAFTA currently uses, but in a positive form, and offers an optional value content method to use.

If the proposed harmonized rules were applied, one of the above two scenarios would occur, depending on the choices eventually made in the negotiations: either scenario would be suitable because the rules in each are flexible, could be applied to all WTO member countries and would not be manipulated pursuant to local interests. The NAFTA triple transformation rule of origin hardly allows for the importation of any imported inputs. As mentioned in Chapter II, it was imposed mainly to protect the US producers of materials from Asian competitors. This happens when textile producers within North America try to satisfy the stringent rule of origin by using inputs sourced from the US instead of Asia. The proposed harmonized set of rules limits the level of stringency and allows local textile producers to source materials from outside North America. This would give the Asian materials a chance to enter the US market and compete fairly with the US materials.

4.2 Trade Diversion.

Preferential rules of origin may cause trade diversion when a final goods producer inside a preferential area tries to satisfy a too stringent rule of origin aiming at diverting his importation of inputs from a cheap external source of supply to a costly internal one. In other words, the final goods producer who used to import inputs from outside the preferential area would not be able to continue its importation of inputs from an efficient external source of supply if it is to satisfy the stringent preferential rules of origin.

Without a harmonized set of preferential rules of origin, countries are free to impose trade-diverting rules of origin in preferential trade regimes. However, the proposed harmonized rules allow the final goods producers in preferential trade areas to use imported inputs from external sources of supply. For example the 60% import value content requirement allows the final goods producers to use a fixed magnitude of inputs imported from anywhere to produce the final the products. Consequently, final goods producers would be able to import inputs from external efficient sources of supply. This means that a final goods producer inside a preferential trade area would still be able to continue importing inputs after the formation of the preferential trade area from efficient external sources of supply, leading possibly to no trade diversion.

The next two tables illustrate the NAFTA ketchup trade-diverting rules of origin

- **The NAFTA now:**

Chapter	Tariff heading	Tariff Sub-heading	Product description	Rule of Origin
21	2103	2103.20	Ketchup	A change to tariff item 2103.20.aa from any other chapter, except from subheading 2002.90

Source: NAFTA

- **The NAFTA after adopting the proposed harmonized rules**

Chapter	Tariff heading	Tariff Sub-heading	Product description	Rule of Origin
21	2103	2103.20	Ketchup	A change to tariff-sub-heading 2103.20 from any other chapter; or a maximum import content of 60% (or 75% for least developing countries)

Source: Author's analysis

According to the first table, a ketchup producer in North America could produce ketchup by using any good classified under any chapter except tomato paste (sub-heading 2002.90). In other words, for the ketchup to be accorded preferences under the NAFTA, North American ketchup producers cannot produce ketchup from

imported tomato paste. This exception of using certain goods represents the application of the specific manufacturing operation in its negative form.

As mentioned in Chapter II, the triple transformation rule of origin was imposed to divert the importation of tomato paste from Chile to Mexico. This means that ketchup producers in North America, who used to import tomato paste from Chile before the formation of the NAFTA, would need to import tomato paste from Mexico instead to satisfy the rule of origin.

The second table presents a change in tariff classification rule of origin with no negative standard (no exceptions). As a result, ketchup producers could import tomato paste from Chile (no exceptions in the tariff classification[345]) and no case of trade diversion would occur. It is to be noted, though, that such a rule would be optional since a 60% import content requirement could be used as an alternative instead. Of course, in that case, the ketchup producers who used to import tomato paste from Chile would pick the change in tariff classification rule since the value content requirement restricts them to using a fixed magnitude of tomato paste (60% of the value of the ketchup).That is why the proposed harmonized rules not only limit the level of stringency, but also offer flexibility for producers.

4.3 Political Purposes.

Preferential rules of origin may be used to achieve political goals. The application of preferential rules of origin could depend on the foreign policies of some countries. In some cases this could lead to negative results and hinder trade. The purpose of preferential rules of origin is to determine whether the good qualifies for

[345] Manufacturing operation in a negative form.

preferential treatment. They were not designed to pursue political aims. The important question is whether the proposed harmonized rules would be able to end the use of rules of origin for political purposes.

In general, adopting a single set of harmonized preferential rules of origin means that each country in preferential trade areas would have to apply this set of rules on imports coming to its market. Consequently, countries would not be able to change or misuse the rules pursuant to their national interests or foreign policies.

As discussed in Chapter II, under the qualified industrial zones, for Egyptian and Jordanian products to enter the US market on preferential terms, the values of Israeli components used to produce the final Egyptian and Jordanian product must be not less than 11.7 % and 8 %, respectively, which equal an 88.3% and 92% import value content requirement.

Qualifying Industrial Zones are cumulation zones. The US clarified that this autonomous arrangement was made to support the peace process in the Middle East. Even though the mentioned percentages are even more tolerant than the 60% provided by the proposed harmonized rules, the utilization of preferences by many Egyptian and Jordanian firms was really low, reflecting their rejection to the use of Israeli components.

Without the qualifying industrial zones, Egyptian and Jordanian firms would not be able to export duty-free to the US because whether the goods could be exported duty-free would depend on whether US law or bilateral treaties between the USA and Egypt/Jordan provided for duty-free trade. Thus, the harmonized proposed rules do not offer an alternative way for the Egyptian or Jordanian products to be exported to the US duty-free. However, Chapter III suggested the elimination of cumulation zones because they may lead to trade diversion. In this political scenario, the elimination of

the qualifying industrial cumulation zones could push countries to find other alternatives, like forming free trade agreements. That is why negotiations to form a free trade area between Egypt and the US are currently taking place as mentioned in Chapter II, which would allow Egyptian exporters to export products to the US duty free and thus increase the utilization rates of preferences without any political restrictions reflected in a value added criterion.

4.4 The Spaghetti Bowl.

The spaghetti bowl phenomenon is the term used to describe the proliferation of rules of origin resulting from the formation of many preferential trade agreements. A country may be member of one preferential trade area and a member of another preferential trade area imposing different rules of origin. This makes things complicated for traders and producers worldwide. The increase in preferential trade agreements year by year in the WTO system leads consequently to an increase in the number of rules of origin with which traders and producers have to comply when seeking preferences.

Having one set of harmonized clear, flexible and transparent preferential rules of origin would lessen the administrative costs, the complexity and the burdens that traders and producers face, regardless of the increase in the number of preferential trade agreements.

Chapter III, Section 4 presented a figure representing the number of preferential trade agreements between the APEC members. If the proposed harmonized rules were adopted, there would be a single line in the figure representing the harmonized preferential rules of origin, applied not only to the agreements between the APEC

members, but to all preferential trade agreements. Thus, the proliferation of different rules of origin would cease to exist if the proposal for harmonizing preferential rules of origin were adopted.

4.5 All Best Possible Outcomes.

Preferential rules of origin could be used for protectionist and trade-diverting purposes if they are too stringent. The proposed harmonized rules of origin are not too tolerant because the change in tariff classification could be applied to products at the chapter level, and the 60% import value content and specific manufacturing operations could still be stringent when applied to certain products. However, the proposal is not too stringent and offers flexibility by offering alternative criteria between which a producer would always be able to choose instead of the mandatory three rules to be complied with in some current agreements. Moreover, the value content requirement is the main method of determining origin. The application of 60% import value content to all products is clear and transparent, which will not make rules of origin complicated for traders and producers. The specific manufacturing operation method is not easy to understand and requires a lot of technicality. That is why it would not be a mandatory requirement and all production operations would be mentioned in a separate attachment so as to not confuse people who are not experts. In summary, adopting the proposed harmonized rules offers flexibility and sets limits to the level of stringency. Accordingly, preferential rules of origin would not be so stringent as to be used for protectionist and trade-diverting purposes, and trade would be facilitated.

Adopting the harmonized set of rules of origin would guarantee the complete elimination of the spaghetti bowl phenomenon. Having a single set of preferential rules of origin applied to all preferential trade regimes would be guaranteed if preferential rules of origin were harmonized.

It is important to take into account the interests of least developed countries. The 75% import value content requirement offers greater flexibility for least developed countries. All WTO member countries seem to have agreed on that pursuant to the Bali decision on preferential rules of origin for least developed countries. As mentioned in Chapter III, WTO member countries finally realized the importance of considering the production capacities of least developed countries, so the proposal ensures that least developed countries would be supported.

Finally, if adopting the proposed harmonized rules would stop countries from imposing protectionist preferential rules of origin, foreign competitors would be able to compete fairly with local producers. Thus, the proposed harmonized rules could ensure the existence of fair competition. Moreover, since adopting the proposal could end the imposition of trade-diverting preferential rules of origin as well, once a preferential trade area was formed, producers who used to import inputs from efficient external sources of supply would still be able to import from the latter. This could boost the efficiency of global production and leave local consumers with more choices.

CHAPTER V

CONCLUSION

Rules of origin are those laws and regulations that are applied to determine the country of origin of goods. A good is conferred origin if it was wholly obtained in the exporting country or has undergone a last substantial transformation. A wholly obtained good is a good that is produced entirely in the exporting country. It is either a natural product or a good produced from natural products, such as minerals extracted from the soil or water, live animals, harvested vegetables or goods produced there from. The last substantial transformation is the concept used to determine the country of origin of the good when more than one country is involved in its production, i.e. the importation of inputs from one or more country was needed to produce the good. The last substantial transformation is indicated by three possible methods: the change in tariff classification, the value added and the specific manufacturing processes.

Upon the importation of a product, each country applies its own rules of origin to determine the origin of the product. That is why rules of origin differ from one country to another. Such rules of origin are known as “non-preferential rules of origin”. Non-preferential rules of origin are mainly used for gathering trade statistics, government procurement, carrying out origin marking and labeling requirements, and the application of trade policy instruments such as anti-dumping duties, countervailing measures and quantitative restrictions. However, there is another type of rule of origin called “preferential rules of origin”. Preferential rules of origin apply in preferential trade agreements. They are used to stipulate whether a good is deemed

to originate in a preferential trade agreement partner country and consequently eligible for preferential tariff treatment.

Although preferential rules of origin play an increasing role and are an important issue in international trade, such rules can be misused. Even though the primary purpose of preferential rules of origin is to determine whether a good qualifies for preferential treatment, they could be used for protectionist purposes when countries use them to protect their own national interests and sensitive goods by imposing too stringent preferential rules of origin. The imposition of too stringent preferential rules of origin in preferential trade agreements and the proliferation of preferential rules of origin worldwide because of the formation of many preferential trade agreements have been hindering international trade.

The imposition of too stringent rules of origin in preferential trade agreements is triggered by two reasons in two different scenarios. The first scenario is when a country uses the preferential tariff as a bait to induce another to form together a preferential trade agreement. Because of such inducement, sometimes the latter country does not pay appropriate attention to the rules of origin when concluding the trade agreement. As a result, internal final good producers when seeking preferences have to comply with the too stringent rules of origin and source inputs from country with protectionist intentions (as in the EU GSP example given in Chapter II).The second scenario takes place when all members of a preferential trade area agree to impose protectionist rules of origin so as to divert trade from an efficient external source of supply to an inefficient internal one(as in the NAFTA rules of origin for ketchup, for example). Also, sometimes rules of origin are imposed in preferential trade agreements to achieve political objectives.

Imposing too stringent preferential rules of origin could lead to negative results and does not facilitate trade. A too stringent preferential rule of origin could be costly when it requires a producer to source expensive inputs from within the trade area for producing the final product. Also, a too stringent preferential rule of origin could be complex when it requires the producer to comply with complicated production operations within the trade area when producing the final product. Moreover, applying too stringent trade-diverting rules of origin affects global efficiency negatively and does not leave consumers with appropriate choices since trade diversion increases the production of inefficient producers in preferential trade areas and shrinks the production of efficient third countries' producers. Preferential rules of origin vary from one preferential trade agreement to another. Their variation, along with their complexity, is considered to be a nightmare for producers and traders all over the world and leads to the so called "Spaghetti Bowl" phenomenon. For instance, things are complex for a trader whose country is a member of a variety of agreements that impose different preferential rules of origin to be complied with. Even large enterprises face difficulties when complying with a diversity of administrative costs provoked by different agreements. Harmonizing preferential rules of origin would eliminate the negative effects outlined previously, thereby helping to liberalize international trade.

This thesis has discussed the negative effects that can result from the misuse of preferential rules of origin and given realistic examples showing how the misuse of rules of origin in different preferential trade regimes hinders international trade. Also, the thesis offered and theoretically tested a proposed harmonized set of preferential rules of origin and gave extensive and technical details on that.

According to some views, the prospects for achieving harmonization of preferential rules of origin could be adversely affected by the WTO's failure so far to harmonize non-preferential rules of origin. The latter were supposed to have been harmonized by 1998, but that deadline has been missed by many years. Moreover, there still remain a large number (94) of issues to resolve. The fact that the WTO operates through consensus and that it has a large and very diverse membership makes it very hard to agree on anything. For example, in 2007 the Committee on Rules of Origin faced some difficulties related to some outstanding issues. Consequently, the General Council recommended the temporary suspension of work on these issues and requested the Committee on Rules of Origin to focus on the overall architecture of the product-specific rules of origin.[346]Even the Bali agreement is now threatened by opposition from India. Furthermore, at the Committee on Rules of Origin meeting in September, 2013, Canada, Australia and the US stated that they did not believe anymore that the harmonization of non-preferential rules of origin would be trade facilitating. However, there is still hope for the harmonization of both non-preferential and preferential rules of origin.

In principle, the harmonization process for non preferential rules of origin is still continuing. The initial mandate has been renewed several times and negotiations are still open.[347]Now, the reference to the negotiating text is G/RO/W/111/Rev.6.[348]

WTO members have been able to sit down and agree. The Bali Package comprises about 16 decisions.[349] India's refusal to support the Bali Package is related

[346] Eighteenth Annual Review of the Implementation and Operation of the Agreement on Rules of Origin (11 December 2012) G/RO/73/Corr.1 <https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S009-DP.aspx?language=E&CatalogueIdList=113894,113756,42239,63777,95766,99813,100889,99180,109525,72172&CurrentCatalogueIdIndex=1&FullTextSearch=> accessed 1 September 2014.
[347] E-mail from Mette Azzam to author (3 September 2013), on file with author.
[348] Draft Consolidated Text of Non-preferential Rules of Origin (n 215).
[349] World Trade Organization, 'Ministerial Declaration and Decisions' (n 334).

to only one decision. This means that all WTO member countries agree on the application of the 75% import value content requirement for least developed countries, which complies with the proposed harmonized set of preferential rules of origin discussed in Chapters III and IV. Moreover, the WTO member countries agreed to find a permanent solution to India's issue by 2017, which could lead to the implementation of the Bali Package by then.

During the meeting of the Committee on Rules of Origin in September, 2013, the EU, China, Switzerland and Chinese Taipei expressed their interest in completing the harmonization of non-preferential rules of origin.[350] Also, the EU has successfully harmonized and simplified its GSP rules of origin.[351] Moreover, a lot of preferential trade agreements rely on the value content requirement for determining origin as explained in Chapter III, so there is a good possibility of implementing the proposed harmonization of preferential rules of origin.

The harmonization of preferential rules of origin should be easier than the harmonization of the non-preferential rules because preferential rules of origin are used to determine the country of origin of the product to decide whether to accord preferences to that product. However, non-preferential rules are used for many different purposes including implementing trade policy instruments, labelling requirements, gathering trade statistics and government procurement. That is why the harmonization of preferential rules of origin would be easier to negotiate.

The spaghetti bowl phenomenon could be the key for the harmonization of preferential rules of origin. The number of WTO member countries is currently 160.[352] Thus, the number of non-preferential rules of origin notified to the WTO is

[350] World Trade Organization, 'Members divided on way forward for rules of origin' (n 333).
[351] Commission Regulation (EU) No 1063/2010 (n 266).
[352] World Trade Organization, 'Members and Observers' (n 27).

fixed (160). On the other hand, the number of preferential trade agreements notified to the WTO is 585. This proliferation of preferential rules of origin worldwide has led to an increase in the administrative burdens that traders face and made a lot of companies aware of the need to harmonize preferential rules of origin.[353] That is why, again, the harmonization of preferential rules of origin is different from non-preferential rules. The academic literature is more focused on the spaghetti bowl phenomenon for the same reason as well. Many economists and professors worldwide support the harmonization of preferential rules of origin, such as Antoni Estevadeordal, Kati Suominen,[354] John J. Barceló III,[355] Rajan Sudesh Ratna,[356] Stefano Inama,[357] Edwin Vermulst,[358] Peter Sutherland[359] and others.

The proposed harmonized rules of origin take into account the sensitivity of some products and at the same time offer alternatives and transparency. With an understanding of the political incentives and sensitive industrial sectors, countries could somehow reach a compromise. The suggested proposal for harmonizing preferential rules of origin might not be perfect for some countries, but it could definitely serve the process of harmonization of either non-preferential or preferential rules of origin.

Finally, it is expected for the reasons mentioned that the WTO member countries would take a decision, sooner or later, to put an end to the increase in the complications caused by not only the misuse of preferential rules of origin, but their

[353] International Chamber of Commerce (n 340).
[354] Estevadeordal and Suominen, 'Rules of Origin: A World Map and Trade Effects' (n 343) 66.
[355] Barceló III (n 300).
[356] Ratna (n 226) 85-88.
[357] Stefano Inama, 'The Value of the WTO Ministerial Decision on Preferential Rules of Origin for Least Developed Countries (LDCs), (2014) Paper Prepared for the UNCTAD Expert Group Meeting for Least Developed Countries: Way forward on the WTO Ministerial Decision on preferential rules of origin, Geneva, 5 <http://unctad.org/meetings/en/Contribution/aldc2014_05_inama_en.pdf.pdf> accessed 12 January 2015.
[358] Vermulst, Bourgeois and Waer (n 224) 483-484.
[359] Peter Sutherland and others (n 187) 22.

proliferation as well. The WTO member countries should seriously discuss the harmonization of preferential rules of origin during the Doha round to overcome the negative effects resulting from their proliferation and misuse for the sake of international trade facilitation.

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